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Barber B. Conable

President's Council files 07
Nov./Dec. - 1987

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DECEMBER 18 MTG.

FORM NO. 89
('-83)

THE WORLD BANK

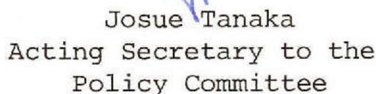
ROUTING SLIP	Date Dec. 21, 1987

OFFICE OF THE PRESIDENT

Name	Room No.
Vice Presidents	
Mr. Yves Rovani	H-6-001
Mr. Heinz Vergin	F-1220
Mr. Alexander Shakow	J-3-073
Mr. Robert Liebenthal	J-3-077

	To Handle		Note and File
	Appropriate Disposition		Prepare Reply
	Approval		Per Our Conversation
XX	Information		Recommendation

Remarks



Josue Tanaka
Acting Secretary to the
Policy Committee

From

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 18, 1987

TO: Members of the Policy Committee

FROM: Barber B. Conable

EXTENSION: 72001

SUBJECT: Budget Framework

1. Following my examination of budget framework issues, I ask that you proceed along the following lines:

(a) annual reorganization cost savings of $ 45 million remain the objective, but may not be fully achievable in FY89. I expect to review the detailed composition of reorganization savings and any lag in the recovery of direct reorganization costs in the next draft;

(b) two scenarios should be developed for further definition of the budget framework. The first scenario should be based on a no-growth assumption from the aggregate FY88 budget. The second scenario should reflect the high scenario in the Budget Framework Issues Paper.

2. While I consider these scenarios to be a good starting point, I will closely examine again assumptions within each scenario which affect the allocation of resources among services and complexes.

3. Considering the complexity of the issues involved and the tight schedule, you and your staff should collaborate with PBD to achieve a timely execution of the budget process. In particular, I expect your units to define specific priorities, identify key trade-offs and derive detailed implications of each scenario. Our ability to justify the budget will depend to a large extent on the quality of your inputs.

4. I have also requested PBD to prepare an issues paper on 'dollar budgeting' and budget incentives and processes for discussion at the Policy Committee in early 1988.

Barber Conable

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 22, 1987

TO: Files

FROM: Josue Tanaka, Acting Secretary to the Policy Committee

EXTENSION: 72101

SUBJECT: Minutes of the Policy Committee of December 18, 1987

Members Present
Messrs. Conable, Hopper, Shihata, Stern

Acting Members

Messrs. Burmester, Jaycox, Stanton

Other Staff Members

Messrs. Challa, Gore, Picciotto, Tanaka

Review of IBRD Liquidity Policy

Following a brief statement by Mr. Conable on the relevance of the paper, Mr. Stern noted that the paper had been requested by the Board and is scheduled for discussion in January. Mr. Stern explained that the paper reflected the basic inability to fine tune liquidity and the resulting need to manage liquidity within a flexible range. Mr. Hopper conveyed that Board members were broadly supportive of the measures proposed. Policy Committee members endorsed the recommendations of the review.

Budget Framework

Mr. Conable opened the discussion by outlining the major questions to be addressed in the definition of the three year budget framework. According to Mr. Conable, these questions involve reorganization cost savings, the level of budget growth, budget priorities and incentives. Mr. Conable considered that the budget will be developed in difficult circumstances related to the significant cuts in the FY88 budget, the current lack of data on FY88 budget performance and the probable reaction of the Board to any budget growth. Mr. Conable noted also that transitional costs associated with the reorganization may have been underestimated, but considered that no additional FY88 budget should be considered at this point.

Mr. Jaycox agreed with the need to maintain reorganization cost savings, but stated that new initiatives are already being taken without having the resources at hand. Accordingly, Mr. Jaycox considered that a key question involved the possibility of budget growth to support new priority initiatives.

Mr. Stern requested clarification on the definition of the basis from which reorganization savings are computed. Mr. Picciotto replied that the basis was the FY87 budget. The FY88 budget reflected therefore savings of $35 million, and the FY89 budget is currently expected to reflect savings of $45 million. Mr. Picciotto mentioned that FY89 savings had to be set at a realistic level, and that additional information was necessary from the units to assess the current FY88 budget situation. Messrs. Hopper, Jaycox and Shihata questioned the static nature of the basis used for the budget as commitments and activities are expected to grow. Mr. Jaycox considered that if political prospects on budget growth were so limited, a $35 million savings for FY89 should be the maximum level of savings envisaged. Mr. Jaycox reiterated that the budget could not remain static in the light of the new initiatives currently being launched.

Mr. Stern requested that PPR be explicitly treated in the budget documentation as trade-offs cannot be reasonably defined in the absence of precise information on one of the complexes. Mr. Stern considered that a precise analysis of the savings was necessary, clearly identifying the source of savings and factors which affect the savings level and the reorganization cost recovery period. Mr. Stern perceived that, while it is difficult to envisage rapid budget growth in the coming years, the political and administrative cost of developing a 1% growth scenario far exceeded the benefits of such a budget increase.

Mr. Hopper felt that a 1% budget growth could be obtained without excessive political cost. Mr. Hopper perceived that, while the Board is not systematically hostile to budget growth, it has to be convinced of the savings actually being made and of the efficiencies being achieved through the reorganization. Mr. Hopper also expressed concern that a no-growth scenario combined with the reorganization savings would result in an actual budget decrease over the three year period.

Mr. Conable requested comments from Committee Members on the appropriateness of a two scenario approach. Messrs. Hopper and Stern agreed with this approach. Mr. Stern considered that the bottom line is the final total budget figure, and that a 1% to 2% annual budget growth can be defended. Mr. Stern considered that the justification for any growth should not only be based on new initiatives, but should also emphasize differences in strategies arising from a zero-growth scenario and a growth scenario. Mr. Shihata found the two scenario approach useful. Mr. Shihata agreed with Mr. Stern that a 1% increase did not justify the staff effort required to develop the alternative and that the growth scenario should be justified on the basis of visible initiatives. Mr. Shihata also mentioned that the taxonomy of services contained in the Budget Framework Issues Paper should be revised. On behalf of Mr. Wapenhans, Mr. Stanton said that the decision on which scenario to put to the Board should follow the Mid-Year review and that the COW meeting should be deferred to February 22, 1988. Mr. Stanton mentioned also that the FY88 budget needed to be corrected to reflect mistakes made during reorganization.

Mr. Shihata felt that the impact of the headroom issue on the level of Bank activities should be assessed. Mr. Picciotto explained that the budget framework has been developed on the high planning assumption, and suggested that the medium planning assumption may be more appropriate

in the light of current uncertainties. Mr. Stern noted that the GCI is constructed on the base case which is the best estimate of Bank activity level.

Mr. Conable concluded this part of the discussion by stating that the two scenario approach with a no-growth and a 2% growth alternative should be developed, and that full support was expected from each unit in the definition of priorities and implications within each scenario. Mr. Conable then turned to the topic of budget incentives by emphasizing the need for more budget responsibility within a decentralized environment.

Mr. Stern considered it was misleading to think that "dollar budgeting" does not exist today as it is already used for all expenditures except personnel. Mr. Hopper noted that personnel represents 70% of the budget. Mr. Stern felt that, while dollar budgeting should in theory lead to more responsible grade structure decisions, it is likely to lead to the end of personnel policy. Mr. Stern perceived that over time personnel policy on matters such as nationality, salary and staff mobility could not be enforced. Mr. Stern felt that the only way to control grade would be to establish a rigid grade structure within each unit. Mr. Stern argued that the Bank is not a market, and that the main incentive would be low cost of labor.

Mr. Conable expressed concern on grade creep. Mr. Stern felt that strict limits should be placed on positions and distributed by unit.

Mr. Picciotto noted that a weighting system is proposed to adjust incentives. Mr. Hopper considered that complementary controls could be implemented, and that dollar budgeting would not be equivalent to total "laissez faire" which could lead in the extreme to an institution staffed by consultants. Mr. Shihata noted that dollar budgeting is not new to the Bank, and was used before 1968. Position budgeting followed a request by the Board in 1968 to define the number of positions in the Bank.

On behalf of Mr. Wapenhans, Mr. Stanton suggested that dollar budgeting should be the subject of a separate discussion. Mr. Jaycox explained that, while Mr. Stern's arguments were known, the Steering Committee had felt that the downside costs of not having improved budget incentives were not acceptable. Mr. Jaycox considered that, in this respect, significant work remains to be done. Mr. Stern considered that the lack of discipline within the institution is the fundamental issue and that problems will remain independently of the system adopted.

Mr. Conable requested that an issues paper on dollar budgeting be finalized for discussion at the Policy Committee. Mr. Conable concluded the budget framework discussion by requesting full collaboration of Policy Committee members and their staff with PBD as the upcoming budget calendar is tight.

JT

POLICY COMMITTEE MEETING

FRIDAY, DECEMBER 18
~~Wednesday, December 16, 1987~~

~~9:30 a.m.~~
10-00 a.m.

AGENDA

~~1. Mexico~~

1. *~~2.~~ Budget Framework: Issues Paper
Draft prepared by PBD (Mr. Robert Picciotto)

2. ~~3.~~ ~~Miscellaneous~~:

** Draft Memorandum to the Executive Directors:
Review of IBRD Liquidity Policy

3. miscellaneous: mexico

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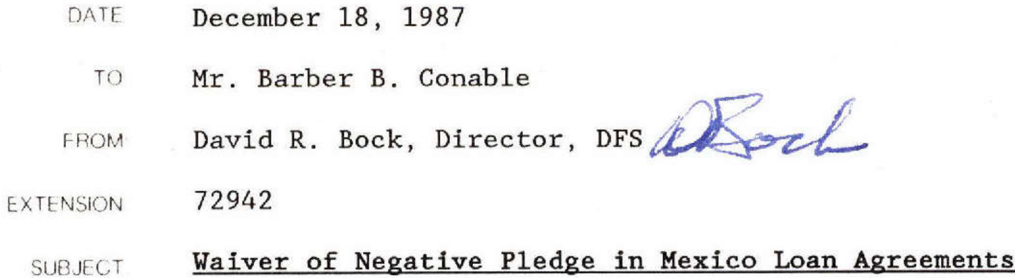
* To be distributed by c.o.b. Friday, December 11
** Attached

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM



DATE December 18, 1987

TO Mr. Barber B. Conable

FROM David R. Bock, Director, DFS

EXTENSION 72942

SUBJECT **Waiver of Negative Pledge in Mexico Loan Agreements**

1. We have been informed by the Mexican authorities that they have formally decided to proceed with a collateralized bond issue, and Mexico's legal counsel have sent a draft of the letter requesting the necessary waiver of negative pledge restrictions contained in IBRD loan and guarantee agreements. The Mexican authorities have also asked that we give some positive indication of support for the transaction at this time. They and their financial advisers believe that an expression of support by us would be of significant help in securing commercial bank participation in the transaction.

2. The Government expects to send the waiver request to commercial banks next week and to begin marketing the deal at the same time. Their target for final acceptance of tenders is the last week of January. They need our formal waiver no later than **January 15**.

3. While we have told the Mexican authorities and their legal counsel that we would grant the waiver if others do so, we still need to respond to their request for an expression of support. And, we need to start consultations with the EDs now in order to be able to grant the waiver formally no later than January 15.

4. Attached for your review is a draft paragraph for inclusion in the Mexican letter to the commercial banks which would state the World Bank's position at this time. A draft Board paper requesting consent is being revised and will be available early next week.

5. We have been informed by the US Treasury that they strongly support the transaction as a positive step in the overall debt strategy. UST plans to help the Mexicans in obtaining the necessary collateral (these efforts are held up at the moment by lack of long bond authority). UST (Conrow and Berger) expressed the hope that we would also be able to lend our support at this time.

Attachment

Cleared with and cc: Mr. Husain

cc: Members of the Policy Committee

DBock:lrd

P-1866

Rider C

The International Bank for Reconstruction and Development (the "World Bank") supports this transaction as a positive step towards eventual resolution of Mexico's external indebtedness problems and has advised Mexico that, if the institutions party to the agreements referenced above grant a waiver of the negative pledge clauses contained in such agreements, the Management of the World Bank would be prepared to recommend to the Executive Directors of the World Bank to approve a similar waiver of the negative pledge clauses contained in its loan and guaranty agreements with Mexican borrowers in order to permit Mexico and the commercial banks to carry out the proposed exchange offer.

{Reference to waivers/consents from other lenders, e.g. Inter-American Development Bank, official credit agencies, export credit agencies.}

CP-file

WORLD BANK/INTERNATIONAL FINANCE CORPORATION
FICE MEMORANDUM

DATE: December 14, 1987

TO: Mr. Barber Conable

FROM: W. David Hopper, SVP, PPR

EXTENSION: 75678

SUBJECT: Budget Framework Issues: PC Meeting of December 16, 1987

1. This Policy Committee meeting will shape budget policy for the next three years. By the end of the meeting, a senior management consensus should emerge around an approach which can be implemented without paying a high price in management goodwill vis a vis the Board.

General

2. At the outset of the meeting, I recommend that you make the following points:

(i) this year's budget is tight. For the first time in the Bank's history the budget was cut in real terms - the FY88 budget was set 4-1/2% below the FY87 budget and 1.7% below actual FY87 expenditures. Another 1.7% had to be diverted to fund the reorganization

(ii) the direct and transitional costs of the reorganization may have been underestimated.

(iii) Nevertheless, you are not prepared to consider a supplemental under any circumstances and you expect managers at all levels to set priorities and take the difficult decisions needed to balance their budgets.

3. You should then firmly set aside the issues of this year's budget since the mid-term information is not yet in hand. The attention of the Policy Committee should be focussed on the paper, i.e. on the budget envelopes and budget policies which the institution will follow over the next three years. You might remind the participants that the paper raises four questions about which you would like to hear views:

(i) how to deal with the reorganization cost savings issues?

(ii) what kind of budget growth is acceptable?

(iii) what should be the priorities for resources allocations?

(iv) what needs to be done to improve budget incentives? You should ask Policy Committee members' comment on each of these questions in turn.

Issue No. 1 (Reorganization Cost Savings)

4. With regard to the reorganization cost savings issue you might conclude by laying out the following guidelines:

(i) the issue of reorganization cost savings should not be swept under the rug. You would like all Units to focus on this issue in their submissions, i.e. outline what they believe the indirect and transitional costs of the reorganization are, how they can be recouped and what is being done to remedy the underlying problems;

(ii) budget targets should be set to recover all direct and indirect costs of the reorganization over a period which does not exceed 3 - 5 years (including FY88);

(iii) the budget framework briefing to the Committee of the Whole should include a realistic assessment of the individual and transitional costs of the reorganization and embody a senior management consensus as to the savings which will be generated to recoup them.

Issue No. 2 (Growth)

5. With regard to growth (from the bases derived after taking account of reorganization cost savings) you should state that you are yet to be convinced that real growth is needed (since there ought to be room for improved efficiencies and redeployment) and you would therefore like to know from all Units what would be the consequences of living within the low scenario outlined in the PBD memorandum. Three points may be made in support of this posture:

(i) Board views are such that we ought to have an extraordinarily convincing case if we are to seek any real budget growth;

(ii) with inflation running at 5% or more, even no real budget growth will be difficult to sell since it inflation will add $42 - 45 million to the nominal budget;

(iii) last but not least, from the standpoint of Units, the low scenario is 3.2% above the amounts distributed this year (if account is taken of the contingency) and 1.7% (if the contingency is excluded) which ought to be enough to meet the managers core priorities of the institution. In other words, at this stage you should resist endorsing the high option which some of the SVPs may press for and you should request Units to work with PBD to elaborate the implications of the three scenarios (including the low scenario) before you take a position on the matter.

Issues No. 3 and 4 (Services Mix and Inter-Unit Allocations)

6. With regard to the priorities for resource allocation you might conclude the debate by stating that:

(i) the core business of the Bank is quality lending and under any scenario, this should be protected.

(ii) the "non-lending" services and "support" functions which had grown rapidly in the mid-eighties should now be carefully reviewed.

(iii) Therefore, you should reiterate that Units should let PBD have the specific implications for their programs of living within the three alternative scenarios laid out in Annex 6.

Issue No. 5 (Budget Incentives)

7. Finally, on budget incentives you might wrap up as follows:

(i) we need to modernize our budget systems and you would like all Units to work with PBD to get this done;

(ii) we should move forward with a realistic step on dollar budgeting in FY89.

(iii) PBD should prepare a report to the Policy Committee on what needs to be done on budget processes by the end of March 1988, i.e. before the Budget Committee initiates hearings on this topic.

A Final Word

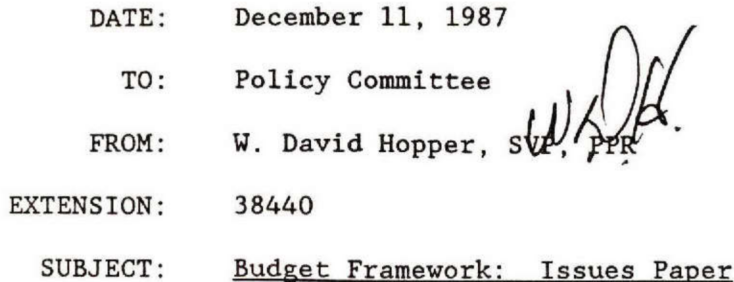
8. You might conclude the meeting by stressing that you would like managers at all levels to give their full attention to internal budget matters in order to decrease the "noise" associated with the topic.

cc: Ms. Haug

RP/WDH

THE WORLD BANK INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM



DATE: December 11, 1987

TO: Policy Committee

FROM: W. David Hopper, SVP, PPR

EXTENSION: 38440

SUBJECT: Budget Framework: Issues Paper

1. The attached issues paper was prepared without the benefit of full planning documentation and ahead of the lending allocations and mid-term review exercises. Given the uncertainties arising out of the reorganization and the lack of reliable information on post-reorganization budget performance, the scenarios presented are affected by more than the usual amount of uncertainty.

2. Nevertheless, I believe that the paper provides a suitable basis for a general Policy Committee discussion of the major elements of the FY89-91 budget framework. Detailed formulation of the scenario(s) finally selected for the COW briefing paper will require analyses of the information to be submitted by Units. This information (see Annex 2 of the issues paper) is crucial to the presentation of budget alternatives which I undertook to provide to the Committee of the Whole.

3. Reorganization cost savings is likely to become an important topic at the discussion of the budget framework by the COW. Its treatment requires the full consensus of senior management. The approach sketched in the attached paper is tentative. Additional work is under way to simulate realistic "with" and "without" scenarios to provide firmer estimates of the reorganization savings expected to materialize. I believe that a thorough, frank and professional budget presentation of the adjustment factors involved in tapping the potential of the reorganization over the medium term would help put the reorganization savings issue in perspective and also help lay it to rest.

4. The design of budget incentives adapted to the decentralized structure of the reorganized Bank is another theme which I would propose to touch upon in the briefing paper to the COW. In this context, tentative proposals for a new mode of presentation of the budget as well as an issues paper on dollar budgeting have been issued to the Senior Budget and Systems Advisers of Units. Additional work on these and other budget policy aspects will take place ahead of the review of budget and planning processes which the Board's Committee on Cost Effectiveness and Budget Practices ("Budget Committee") proposes to undertake in the Spring of 1988. Policy Committee advice on the general direction of this work would be valuable.

cc: Ms. M. Haug

P-1867

WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 11, 1987

TO: Policy Committee

FROM: Robert Picciotto, Director, PBD

EXTENSION: 38440

SUBJECT: BUDGET FRAMEWORK: ISSUES PAPER

1. Policy Committee (and to secure the participation of Managing Units) towards the preparation of the FY89 Budget Framework and the briefing paper due to the Committee of the Whole on February 1, 1988.

2. The management paper on FY89 Budget Priorities and Policy Directions took the stance that a choice had to be made between real budget growth and lending targets or service levels. Annex 1 provides a synopsis of the Committee of the Whole meeting which considered this paper on November 25, 1987. With a few exceptions, the response of the Executive Directors was either non-committal or adverse to budgetary expansion. While the door was not slammed shut on the possibility for some budget growth (should management conclusively demonstrate the need), management was urged to exercise utmost restraint and to concentrate FY89 efforts on tapping the full benefits of the reorganization.

3. Given this background, it is recommended that the budget framework paper be designed:

(a) to confirm that management expects substantial savings to arise as a result of the reorganization, in line with the estimates provided when the reorganization budget increment was approved by the Executive Directors ($45 million full-year savings);

(b) to demonstrate that substantial efficiency increases and resources redeployments are slated to take place under the FY89-91 work programs being formulated in support of the policy directions of the President's Annual Meetings speech;

(c) to lay out credible budget scenarios relating alternative budget growth assumptions to different levels and mixes of clients' services;

(d) to outline the directions of budget policy in support of effective priority setting, cost consciousness and accountability within the decentralized management structure of the new Bank.

4. Active involvement of the Managing Units is required to complete work on the framework. The information requested from Units is listed in Annex 2.

Issue 1: Reorganization Savings

5. The most delicate issue relates to the treatment of reorganization savings. It needs to be dealt with convincingly in the framework documentation in order to lay it, once and for all, to rest. The three-year planning horizon coincides with the period during which shareholders expect the Bank to recover the direct costs of the reorganization through salary savings, efficiency improvements and economies of scale. The FY88 Budget postulated that the full-year cost savings of the reorganization would amount to $45 million. The Policy Committee should consider whether this estimate should be confirmed or revised. Two considerations would argue for a downward adjustment in the estimate: (i) there is evidence of grade inflation having taken place in the wake of the reorganization; (ii) potential reorganization savings require complementary investments and/or involve transitional costs which were not adequately budgeted for in FY88. On the other hand, one would expect increased salary costs to be matched by efficiency improvements (especially with the additional flexibility expected to be provided to managers through dollar budgeting). Furthermore, the credibility of management would suffer from a premature and, so far, unsubstantiated downward revision of the reorganization savings estimates submitted to the Board when the budget supplement was approved. Therefore, it is suggested that the budget framework paper be based on a reiteration by management that it plans to shape budget policy so as to deliver full-year reorganization savings of about $45 million but with a lag of about two years. Specifically, it is recommended that the framework be based on full-year reorganization savings of $35 million in FY89, $40 million in FY90 and $45 million in FY91.

Issue No. 2: Budget Growth

6. Confirmation that management remains committed to the savings objectives of the reorganization would strengthen the case for moderate budgetary expansion to accommodate: (a) the growth requirements of GCI/IDA-8; (b) the indirect and transitional costs of the reorganization, especially as regards the pipeline, project supervision, economic/sector work and systems buildup needs; and (c) the special requirements of the new policy directions set in the President's Annual Meetings speech. We hope to make use of a retrospective of the past 10 years which would demonstrate that the baseline and the growth rates of the selected scenario(s) embody a sharp break with past budget growth trends as a direct result of the reorganization. Against this background, three alternative budget scenarios would be formulated for review by the Policy Committee and, thereafter, the Board -- a low scenario average of about zero real growth; a medium scenario with about 1% per annum real growth and a high scenario with about 2% per annum real growth. All three scenarios would give priority to the creation of capacity for lending, borrowing and investment, consistent with the realization of the high commitment/disbursement scenario of the planning

assumptions (Annex 3). On the other hand, the three scenarios would differ significantly with respect to the level of resources allocated to non-lending client services and supporting programs. The specific implications of these scenarios would be developed in close collaboration with the Units responsible for the programs involved in order to provide a clear justification for the scenario(s) ultimately selected by the President for recommendation to the Board. Alternatively, a single scenario could be selected upfront following a PC meeting. However, even in this eventuality, Units would have to document the opportunity costs implied in the selected budget growth scenario for their Units and demonstrate the nature of redeployment/efficiencies embedded in the selected scenario. A technical annex providing the methodology and assumptions under the framework scenarios is attached (Annex 4). One aspect worth highlighting is that given the expected annual price escalation rate of 5-6%, the nominal FY89 budget growth would be in a range of $37-45 million from the FY88 budget.

Issue No. 3: Services Mix

7. In order to guide the Policy Committee review of alternative budget scenarios, a model has been developed which assigns resources to 19 programs, grouped into three major service categories: (a) Operating and Financial Services; (ii) Advisory and Client Services; and (iii) Support Services. Annex 5 provides a tentative services-based model of alternative budget growth scenarios. As noted in paragraph 5 above, some front loading of budgetary requirements is proposed to accommodate the consolidation requirements of the reorganization. In general, the approach used was to assess transitional post-reorganization as well as growth requirements for each program consistent with the COW's response to the Budget Priorities and Policy Directions paper, which emphasized the delivery of lending, advisory, and technical assistance services to clients and stressed the desirability of increased efficiency and budgetary restraint for other categories. Lack of planning data and the significant amount of uncertainty now prevailing has constrained the reliability of the scenarios and underlies the need for a contingency of 1-2%. Therefore, validation by Units of the permissible growth assumptions for each program is sought. In addition, work program information is needed on efficiency gains, redeployment and, where appropriate, "output" expectations related to alternative growth levels.

8. With respect to the lending program, Operations should put forward its views with respect to the assumptions made regarding: (a) average size of operations; (b) coefficients; (c) pipeline buildup targets; (d) projected droppage rates; (e) sectoral mixes; (f) lending instruments; (g) regional emphases; (h) size of supervision portfolio; and (i) project completion reporting. With respect to the borrowing program, Finance should give due consideration to the benefits of alternative market diversification strategies since this is a major determinant of the average size (and budgetary costs) of borrowing. Regarding investment operations, the budgetary implications of the proposed liquidity policy need to be articulated. As for loan administration, information is needed on the likely progress of cost reduction programs. In all categories, unit cost economies would be expected to result from the skills improvements and

streamlined processes associated with the reorganization although, given the uncertainties, it would be proper to avoid rigid presumptions on this account.

9. Given the early stage of program definition with respect to the HICs, food security in Africa and poverty alleviation in Asia, it is obvious that the budgetary implications of the new policy directions cannot be known with precision. Nevertheless it would be useful to advise the Board that examination of the budgetary consequences of recommended approaches would be taking place in the context of work programming and task force deliberations. In the meantime, available information should be provided by the Units concerned for use in the framework paper preparation. Equally, data should be given regarding the progress of the FY88 new initiatives since these are linked to the overarching themes of the FY89 budget and the Executive Directors will expect to be brought up-to-date regarding their implementation.

10. In general, we have been given to understand that the budgetary needs of Operations will increase to accommodate the following requirements: (a) increased advisory assistance to member countries for the design, implementation and monitoring of adjustment and poverty alleviation programs; (b) greater involvement in debt management programs and the marshalling of resources for debt workout plans; and (c) enhanced technical assistance and aid coordination programs. Less clear is the dimension of these needs and the extent to which they can be met through more effective management of the resources already built into the base for the same purposes.

11. The new policy directions are also expected to impact on the focus and content of research, training, policy and evaluation programs. It would be helpful for the managers of these programs to carry out an examination of the potential consequences of the alternative budget assumptions laid out in the Annexes. A similar exercise is suggested for each of the special grant programs.

Issue No. 4: Allocations by Units

12. Once the levels of service for individual services are determined, budgets for managing units can be sized. In most cases, services are provided by single units and mapping is easy. But where multiple units are involved (such as in PPR and Operations), mapping was attempted using actual TRS data for FY87. Resulting budgets by managing units for each of the fiscal years and for each aggregate growth scenario are given in Annex 6. Units should consider whether adjustment of growth assumptions and/or work priorities would be necessary to live within each Unit's resource envelope. Policy Committee guidance is needed as to whether the allocations calculated here should be revised to incorporate more (or less) support across Units.

13. A major source of uncertainty relates to the inter-Unit shifts which could emerge out of the midyear review. While these shifts will not affect the calculations of the aggregate budget envelopes, they will have implications for relative progress of work programs and for the implementation of post-reorganization systems needs. Hence, the FY88 midyear review is an integral part of the iterative process which will eventually lead to the detailed definition of FY89 Budget and Work Programs for each Unit. Hence, the decision was made to combine both exercises and for Units to furnish to PBD consistent and updated budget and work program information for FY88 and FY89 by January 4, 1988.

Issue No. 5: Budget Incentives

14. PBD is continuing work on the proposed move towards "dollar budgeting" (DB), and expects to submit to the Policy Committee an issues/options paper on this subject in January. Our judgement is that it should be feasible to put into effect a version of DB that would move to nominal budgeting with respect to staff salaries and average benefits starting from July 1, 1988. Such a move would encourage expenditure switching away from the expensive and monolithic position-driven system of incentives which now prevails. If accepted for implementation in FY89, it should facilitate realization of the outer years' dollar budget framework options discussed above. Some consultation with the Committee on Cost Effectiveness and Budget Practices will be necessary before we put such a scheme into effect. Assuming a switch to the new scheme in FY89, we might still need to continue to indicate staffyear and benefit budgets in the Board documentation, e.g. as memorandum items in this first year of its implementation.

15. The timely implementation of a DB system, as recommended by the Steering Committee, will call for cooperative design of a budget incentives system consistent with the management information and human resources improvements being considered by various groups in Operations, Finance, PPR and Administration. Among the issues requiring resolution are the budgetary treatment of long-term consultants, the arrangements for cross-support and chargeback, the harmonization of YMR processes with DB requirements, etc. A Budget Incentives and Systems Working Group with representatives from each of these units is being assembled to oversee the work and to ensure management readiness for the review of budget processes planned by the Board Committee on Cost Effectiveness and Budget Practices. This formal review by CEBP is expected to begin after completion of Committee's deliberations on the Bank's travel policy, i.e. around March 1988.

16. Unit budgets shown in the framework would also have to be adjusted, if necessary, to reflect the impact of any changes in the pricing of chargeback services. Any such adjustments would be made consistent with the principle that the purchasing power of units (volume of chargeback services that can be purchased) will be maintained at FY88 levels. Similarly, any changes in the Bank's cost recovery policy for the services it provides its clients -- a topic that has been raised by the Executive Directors -- would have to be incorporated through appropriate adjustment in the framework.

17. Deriving the full benefits of the further decentralization of management responsibility that has been put in place as a result of the reorganization will require enhancement and updating of the Bank's planning and budgeting systems. In particular, as indicated by the Reorganization Steering Committee, a bottom-up budgeting procedure helping managers to identify, rank and appropriately size alternative resource claims would have to be meshed with a program/service budgeting system which links resource allocations at the institutional or SVP level with the institution's annual objectives, strategic themes and the planning of human resources, technology and other support services for the Bank as a whole. It is clear that in establishing the medium-term budget framework for future budget cycles, such an enhanced system enabling explicit identification of resource allocation priorities and trade-offs within and across units would be of critical importance.

18. A related initiative which is being explored by ITF -- and will require the full cooperation of all Units -- involves the design and development of innovative business processes with the potential to transform the production function of major areas of Bank activity, yielding promise of significant productivity gains through cost-reducing applications of modern technology.

Recommendations

19. The Policy Committee is requested to confirm the following parameters of the budget framework:

(a) full-year reorganization cost savings would be in line with FY88 Budget estimates but with a two-year lag (para. 5);

(b) preparation of FY89-91 planning and budget scenarios would be based on the high planning assumptions of Annex 3 and the framework model of Annexes 4 and 5 (paras. 7 and 12);

(c) final determination by the President of the scenario(s) to be put forward to the COW; the eventual presentation of the chosen framework to the COW would draw on unit submissions of their respective proposed budget strategies along the lines as indicated in Annex 2 (para. 6).

cleared with and cc: Mr. Hopper

Committee of the Whole Meeting
on Budget Priorities and Policy Directions
(November 25, 1987)

1. Under the new budget procedures, the Committee of the Whole meeting on priorities and policy directions is intended to set the stage for budget formulation. The purpose of this synopsis is to draw the main implications of the November 25, 1987 meeting for the design of the FY89 Budget Framework.

Overview

2. The tone of the Committee meeting, set by Mr. Hopper at the outset, was frank and informal. Appreciation was expressed about management's readiness to consult with the Directors about the budget, early in the process. Criticism was widespread but couched constructively - sometimes humorously. All Directors (or Alternates) present spoke.

3. In general, Executive Directors reserved their options pending provision of more detailed data and, specifically, data on cost savings from the reorganization. Skepticism was voiced about the need for any budget growth. Therefore, an exceedingly strong case would have to be developed to secure consensus for growth, given the widespread perception that additional savings and expenditure switching should be possible and that tight budget pressure should be maintained in order to keep the Bank efficient.

Budgetary Growth

4. Most Directors were uncomfortable with the choice between budgetary growth and service levels put forward in the management document. Only Messrs. Ben Younes and Milongo unequivocally supported the need for budget growth. There was unanimous emphasis on the need for efficiency. Mr. Potter, in an otherwise supportive statement, said that the paper left the Directors in the dark about the practical consequences of the choices offered. Mr. Keating said the U.S. would not support significant real increases in the budget unless it was convinced that all steps had been taken to achieve maximum efficiency. Mr. Draghi thought that much more information was needed to permit a judgment as to the balance between growth requirements and the resources which might be freed through efficiency gains. Other chairs put the same points even more sharply. Mr. Ishikawa stated unequivocally that his country wanted no real budget growth. He said that it was important that the Bank not lose momentum on last year's spirited budget strategy. Mr. Michael von Harpe expressed concern about the pre-reorganization philosophy which might be laying behind the paper, i.e. an' apparent neglect of potential efficiency gains which could lead

to a revival of Board-management tensions on budgetary matters. Similarly, Mr. Sherwin found the paper self-serving and not helpful in determining the nature of trade-offs. Mr. Debains said a period of consolidation was desirable and discipline would continue to be needed to keep the Bank efficient. Mr. Luschin thought that it did not make sense to discuss the need for budget growth at this early stage. And Mr. Faint complained about the phraseology of the management paper (which, he claimed, a Treasury man might view as unforgivable) since it appeared to negate the possibility of expanding services while constraining the budget. In the same vein, Mr. Rao Sahib expressed mild surprise that management would link lending growth so tightly with budgetary growth while it had not done so in recent years when the number of lending operations hardly grew. Mr. Zhang said that no solid evidence had been adduced to support the need for budgetary growth and added that there was no inevitable linkage between the quality of services and their cost. Finally, Mr. Suraisry stressed the need for prudence and for setting priorities within a constrained resource envelope rather than resorting to a budgetary philosophy emphasizing "increments".

Reorganization Savings

5. Underlying the general unease about budgetary growth was the fear that this might signal a retreat from the undertakings given by management about the potential savings of the reorganization. This concern was specifically put forward by Messrs. Keating, Sherwin, Draghi, Michael von Harpe, Haxthausen, Rao Sahib, Zhang and Suraisry. Mr. Rao Sahib made specific reference to recent statements by senior Bank managers about the decrease in internal reviews in the wake of the reorganization which had led him to conclude that these improvements should be reflected in increased efficiencies. The point was articulated more forcefully by Mr. Faint who said that his authorities would insist that reorganization savings recoup the costs of the reorganization within the three-year payback put forward by management when the latest supplement was approved.

Budget Priorities

6. (a) Mr. Zhang referred to lending as the core of our core business;

(b) Messrs. Draghi and Sherwin highlighted the importance of supervision;

(c) most Executive Directors disliked the idea of adjusting the sectoral mix or the mix of lending instruments merely to better live within budget constraints. Nor was there any support for slowing down pipeline-building pending approval of the GCI.

(d) several Directors argued for tighter allocations to advisory and other kinds of clients' services;

(e) a number of Directors expressed support for a greater catalytical role for the Bank regarding other sources of finance (although Messrs. Faint and Rao Sahib pointed to the need of avoiding too close an embrace with commercial banks which, it was stressed, should bear the full risks of their own operations);

(f) Mr. Keating stressed that support services should enjoy the lowest priority in budget allocations;

Objects of Expenditures

7. Mr. Keating expressed displeasure about the Bank's travel policy. Mr. Debains said that his authorities would oppose an expansion in the number of authorized positions in FY89. (The underlying sentiment that the budget should be constrained until the dust had fully settled on the reorganization and consolidation achieved was echoed by several other Directors). Mr. Al-Sultan thought that excessive travel should be contained and that Bank procurement of goods and services could be more cost effective.

Budget Policy

8. Several Directors (Keating, Sherwin, etc.) thought that the Bank should more systematically explore cost recovery possibilities. And there were many interventions (Potter, Keating, Al-Sultan, Faint, Luschin) pointing to the important linkage between net income considerations, market perceptions and the need for budgetary restraint. Mr. Al-Sultan was especially keen to see that explicit priority be given to programs designed to improve collections.

9. Regarding budget processes, there were repeated references to the need for presenting the costs and benefits of alternative budget scenarios, involving greater transparency in resource redeployment, and more transparent analyses of trade-offs. In particular, Mr. Sherwin argued that systematic cost accounting was needed for improved budgeting. And he, along with others, voiced the expectation that the budget framework paper would provide quantitative options and scenarios, i.e. a price list for the appetizing menu of the President's speech.

Implications for Budget Framework

10. The Committee of the Whole meeting on budget priorities and policy directions was designed to set the stage for the budget framework paper. Given the recent history of Board-management relations on the budget, it would be desirable to demonstrate full management responsiveness to the guidance offered by the Committee.

11. Clearly, the budget framework paper for the Committee of the Whole will have to contain quantitative detail on cost savings from the reorganization and make a very strong case for any proposed growth, however modest. In particular, the paper will have to include quantitative analyses of the budgetary consequences of policy options as well as an assessment of the resources that might be freed through cost savings.

12. To be fully responsive to the Committee of the Whole, the budget framework paper should also address certain other concerns expressed by the Executive Directors. The need for strengthening the Bank's planning and budget processes has assumed special importance in the reorganized Bank, and in fact will be examined by the Board's Budget Committee early next year. It is recommended that the framework paper should announce the creation of a Bankwide task force to study the subject and make recommendations before the Budget Committee begins its deliberations in March 1988. Among the topics to be covered by such a task force would be the pros and cons of cost recovery for Bank services and the improvements in specific budget incentives (including dollar budgeting) which are being designed in accordance with Steering Committee recommendations.

Annex 2

Medium-Term Budget Framework (FY89-91)
Information Needed For FY89 COW Paper

1. For the briefing of the Committee of the Whole on the budget framework we would need to characterize more fully the option(s) chosen by the Policy Committee describing explicitly the components of budget growth for expanding the volume of Bank services and undertaking proposed new initiatives, as well as potential cost savings and efficiency improvements. The Executive Directors have requested, and Mr. Hopper, agreed that we would present to them as explicitly as possible, the available choices and tradeoffs among resource allocation priorities.

2. Thus, we will need to describe, as explicitly as possible, the programs which each major organizational unit proposes to pursue or modify within the proposed framework option. In particular we need a description and associated resource requirements related to:

(i) expected growth in the volume of resources delivered by the unit;

(ii) new priority programs and initiatives expected to be undertaken by the unit in line with the objectives outlined in the president's speech;

(iii) work related to the accommodation of programs and processes to the post-reorganization Bank, the transition arrangements; correction of any resulting anomalies, and the corresponding costs;

(iv) proposed changes in business processes or service levels to bring about cost savings and efficiency improvements; and

(v) proposed redeployment of resources across departments or programs.

3. PBD is already in contact with Units to follow up on and articulate the proposed budget strategy for each Unit along the above lines.

Medium-Term Budget Framework (FY89-91)

Planning Assumptions

1. The lending assumptions through FY91 have been retained as in the FY88 Budget document. IBRD commitments for FY92 have been extrapolated at $1.5 billion above FY91 (i.e. to $22.0 billion for the base case). The IDA assumptions do not show high and low cases but only a base case, which similarly has been taken from the FY88 Budget; FY91 and FY92 IDA commitments have been increased by SDR200 million each year above the previous year's commitment level. The table below shows projected commitments for the period FY88-92.

PROJECTED IBRD AND IDA COMMITMENTS

($ billion)

Commitments	FY88 current Estimate	Projections			
		FY89	FY90	FY91	FY92
High Case	-	19.5	21.0	22.5	24.0
Base Case	15.5	17.0	19.0	20.5	22.0
Low Case	-	14.5	15.0	16.0	17.0
IDA					
-In SDRs	3.2	3.6	3.9	4.1	4.3
-In US$	4.3	4.9	5.4	5.6	5.9
Memo					
Total Commitments (IBRD Base Case + IDA)					
-Nominal	19.8	21.9	24.4	26.1	27.9
-Real (FY88)	19.8	21.3	23.2	24.1	24.1
Commitment Deflator	100.0	102.7	105.4	108.2	115.8

2. The IBRD financial projections attached assume a GCI of $80 billion and paid-in amounts of $395 million for the next five years (there also remain unpaid amounts for previous capital increases which will be paid in the next years). No additional loss provisions are assumed after provisioning loans outstanding to Nicaragua. The financial projections for IDA attached were prepared in June 1987 and are being updated. The differences in IDA commitment levels in dollars arise from the use of updated SDR-$ conversion rates.

3. A detailed lending allocation review covering the next five years is currently in progress.

4. The projections use commitment and disbursement deflators calculated in August 1987. These are currently under review by the Planning Assumptions Committee.

IBRD/IDA FINANCIAL AND OPERATING PROGRAMS AND FY89 BUDGET
IBRD: FINANCIAL AND OPERATING DATA FY87-FY92
($ millions)

BALANCE SHEET	Est. FY87	Est. FY88	Projected FY89	Projected FY90	Projected FY91	Projected FY92
Cash and Investments	18302	18519	16629	18456	19976	22141
Total Loans	120458	128839	137171	146524	156410	166883
Less: Undistributed	44696	48346	52067	56627	61623	66959
Disbursed and Outstanding Loans	75792	80493	85104	69897	94787	99924
Net and Other Assets	740	787	836	889	944	1003
TOTAL ASSETS	95334	99799	104569	109242	115707	123068
Short-term Borrowings	4498	4798	5298	5798	6000	6000
Long-term Borrowings	77249	80272	82894	86343	91811	98415
Loss provisioning	85	130	175	220	220	220
Due to IDA	720	620	820	495	245	0
Due to African Facilities	150	150	0	0	0	0
Usable Capital	4942	4994	5648	6043	6438	6833
Reserves	7690	8635	9734	10343	10993	11600
TOTAL LIABILITIES AND CAPITAL	95334	99799	104569	109242	115707	123068
INCOME STATEMENT						
Income from Investments	1505	1360	1521	1506	1558	1765
Income from Loans:						
Interest	5878	6312	6699	7066	7451	7857
Commitment Charges	277	293	317	343	374	408
Front-end Fees						
Total	6156	6606	7016	7409	7825	8265
Net Other Incomes	24	12	11	10	9	8
Less: Borrowing Expenses	6047	6508	6713	6921	7266	7776
Administrative Expenses and Contributions to Spec. Prog	484	525	540	575	602	630
Loss Provision	41	45	45	45	0	0
NET INCOME	1113	900	1250	1384	1524	1632
Memo Items:						
Commitments						
Nominal	14188	15500	17000	19000	20500	22000
Real (FY88 $)	14346	15500	16553	18027	18946	18998
Deflator	0.989	1.000	1.027	1.054	1.062	1.158
Disbursements						
Nominal	11408	11159	12564	13747	14596	15720
Real (FY88 $)	12059	11159	12330	13231	13783	14719
Deflator	0.946	1.000	1.019	1.039	1.059	1.068

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1) Loss provisions only provide for loans outstanding to Nicaragua.

2) The projections assume total administrative expenses (IBRD and IDA) of $878 in FY91. The three options discussed in the memorandum yield administrative expenses of $852, $878 and $904 million respectively for FY91.

IDA FINANCIAL AND OPERATING DATA, FY80-90

($ millions)

	Actual							Projected			
ASSETS	FY80	FY81	FY82	FY83	FY84	FY85	FY86	FY87	FY88	FY89	FY90
Cash Available for Disbursement	114	284	337	275	372	440	187	100	100	100	100
Investments, Notes & Receivables a/	8642	7985	9109	8987	9391	8948	11742	14821	15938	16910	17549
Receivable from IBRD	789	821	747	847	1047	1142	525	725	725	725	725
Total Credits	20722	23842	26119	29102	31557	33997	39592	43616	47531	51916	56611
Less: Undisbursed b/	9696	10965	11242	11734	11834	12002	13747	14994	15769	16844	17869
Credits Outstanding	11026	12877	14877	17368	19723	21995	25845	28622	31762	35072	38742
Net Other Assets	366	318	238	281	282	282	340	383	380	380	380
TOTAL	20937	22285	25308	27758	30815	32807	38639	44651	48905	53187	57496
SOURCES OF ASSETS											
Payable to IBRD	57	138	62	63	52	31	84	0	0	0	0
Fund Balance	-66	-84	-151	-220	-291	-355	-341	-296	-172	-24	150
Cumulative Translation Adjustments c/	-	-2	-17	-38	-110	-182	693	1457	1457	1457	1457
Subscriptions, Contributions & Grants	20946	22233	25414	27953	31164	33313	38203	43490	47620	51755	55890
	20937	22285	25308	27758	30815	32807	38639	44651	48905	53187	57496
SUMMARY OF ADDITIONS/REDUCTIONS TO FUND BALANCE											
Income from:											
Investments	11	16	25	18	18	23	60	110	80	82	99
Credits:											
Service Charges	78	90	105	122	140	158	181	210	227	251	275
Commitment Charges				7	19	29	44	57	60	65	70
Less: Administrative Expenses	140	180	193	214	249	273	280	332	243	251	270
OPERATING INCOME/LOSS (-)	-51	-74	-63	-67	-72	-63	5	46	124	147	174
Exchange Adjustment	-1	13	-4	-2	1	-1	9	-	-	-	-
Additions/reductions to Fund Balance	-52	-61	-67	-69	-71	-64	14	46	124	147	174
Memo Items:											
Credit Approval	3838	3482	2686	3341	3575	3028	3140	3450	4150	4650	5000
Disbursements	1411	1878	2067	2596	2524	2491	3155	3000	3300	3500	3900

a/ Notes and Receivable are contributions held in non-interest bearing notes and bank deposits.
b/ Undisbursed amounts include both effective and non-effective credits, excluding amounts sold or agreed to be sold.
c/ Represents translation adjustments relating to the revaluation of SDR denominated credits.

Financial Policy & Analysis Dept.
June 11, 1987

Technical Annex on the Proposed Framework

Anchors for the FY89 Budget

1. Two budgetary anchors are important for this framework. For the purpose of judging increments in the budgets of individual units in comparison with FY88, the "base" used is the FY88 distributed budget excluding allocations which were made for completing the reorganization implementation.

		$million (in FY88 prices)
FY88 distributed budget		746.0
Less		
Reorganization contingency	7.8	
Reorganization implementation fund	7.2	
Salary used to fund reorganization	5.5	
Miscellaneous (TAP subsidy, salary contingency)	2.4	22.9
"Base" for formulating FY89 unit allocations		723.1

2. The second, the post-reorganization baseline, represents the notional level of the Bank's budget after taking into account the savings from the reorganization.

	FY89	FY90	FY91
FY87 budget (in FY88 prices) 1/	781.5	781.5	781.5
Expected Reorganization Savings	35.0	40.0	45.0
Post-reorganization baseline	746.5	741.5	736.5

From the shareholders' perspective, any increase in the budget over and above the baseline levels would have to be justified in light of the Bank's expanded scope of lending and non-lending services during the post reorganization period, taking full account of additional efficiency improvements. Given that there are still several uncertainties related to the reorganization and that some specific systems investments will have to be made in FY89 to capture the full benefits of the reorganization

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1/ This appears to be a defensible pre-reorganization baseline. A technical annex will elaborate on its justification in the framework paper.

(para. 5), the full savings potential of $45 million from the reorganization is now expected to be achieved only in FY91. This would delay the payback period by about 4 months.

Aggregate Budget Scenarios

3. Three alternative scenarios for the Bank's overall budget growth are examined as medium-term (FY89-91) framework options:

(i) a low scenario with zero real budget growth, under which the budget in real terms is constrained not to exceed the post-reorganization base line referred to above in each of the years FY89-91;

(ii) a medium scenario representing a 3% real growth over the three-year period *vis-a-vis* the above base line; and

(iii) a high scenario representing a 6% real growth over the three-year period *vis-a-vis* the base line.

Relative Priorities Among Services

4. Within the broad limits set for the Bank's budget under a given alternative, the focus is on establishment of relative priorities for services offered by the Bank. For this purpose, the Bank's services have been classified into three main groups, further subdivided into 19 specific service categories:

(i) Operating and Financial Services, which are directly related to lending and borrowing operations;

(ii) Advisory and Client Services, which are necessary to enhance the effectiveness of the Bank's assistance to clients; and

(iii) Support Services, which are internally oriented.

Within this framework, we have made the following conjectures about the growth of the different categories.

a. Operating and Financial Services, 1/ which are directly related to lending and borrowing operations, have been given the highest priority in the allocation of the Bank's resources which is consistent with the COW directions. Given the likelihood of the GCI and IDA-8, these services are expected to grow in the medium-term. The volume of growth would be a function of commitment planning assumptions, average size of projects, complexity of borrowings, process efficiency gains, etc. The input/output relationships in this group of services

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1/ Includes Lending, Supervision, Financial Operations and Loan Administration.

are known more precisely. As in previous years, the Bank is expected to possess a capacity compatible with the highest levels of lending and borrowing operations. Therefore, the volume of growth of services in this group is assumed to be the same under all three alternative scenarios.

b. Advisory and Client Services.1/ The demand for these services has been growing, and they are important for improving the effectiveness of the Bank's assistance to clients. In this framework, the Advisory and Client Services have been accorded the second highest priority next to the Operating and Financial Services. Furthermore, within this category, priority has also been given to economic and sector work (ESW) and technical assistance and coordination. For one, there is a more direct relationship between these services and lending work. For another, particularly for ESW, there is a need for substantial additional resources to enhance the Bank's understanding in the areas of structual and sector adjustment, poverty alleviation, environment, and women in development. In general, however, it is difficult to estimate resource requirements for Advisory and Client Services, where input/output relationships are not clearly defined. The approach taken in this framework is that, whenever resources permit, priority for resource allocations has been given to this group.

c. Support Services.2/ In this framework, Support Services have been accorded lesser priority for growth than the other two groups of services discussed above. To some extent, this is reasonable, given that support services do not have to grow at the same rate as the other two groups of services. Equally important, it is also necessary to control growth in Support Services for political reasons.

Investment In Systems

5. Several managing units indicated that realizing the expected savings from reorganization would require significant "up-front" investments in systems. Accordingly, a notional amount of $4.3 million has been included in the FY89 budget under all budget scenarios, tentatively distributed as follows: decentralization of the accounts payable and payroll functions ($1 million); decentralization of the human resources, consultants and benefit functions ($1.5 million); strengthening institutional

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1/ Includes Economic and Sector Work, Technical Assistance and Aid Coordination, Research, Policy Work, External Relations, Financial Technical Assistance and Special Grants.

2/ Includes Financial Support, Financial Policy, Operational Planning, Operational Evaluation, Personnel and General Support, Legal and Coporation Management.

planning ($0.3 million); and incremental depreciation relating to 'Computers For All' proposed ($1 million). This tends to inflate the budget growth rates for the 'Support Services' categories in FY89. However, these investments are considered to meet one-time needs and the corresponding budget increments are, in effect, reversed in FY90.

6. Annexes 4.1 to 4.3 to this Annex provide further details of the assumptions made with regard to the Operational, Finance and Administration work programs. Obviously, managing units will have to validate the various assumptions and the associated resource requirements based on their full review of work programs.

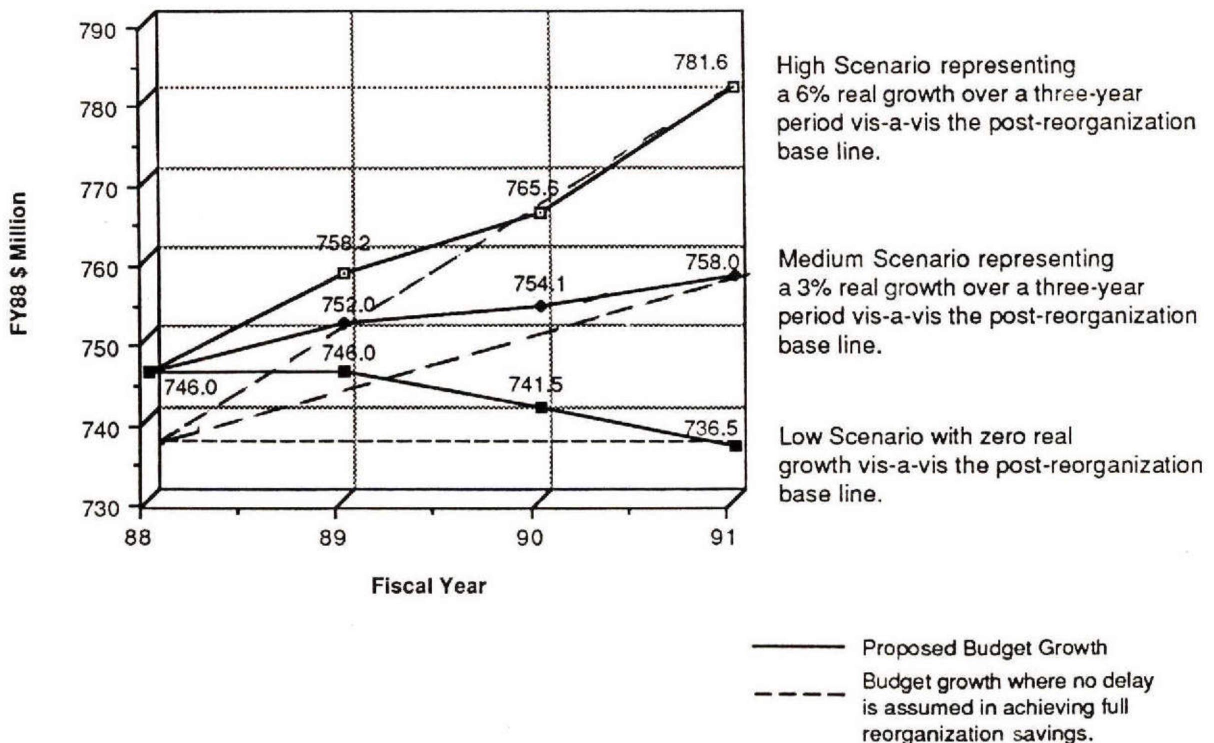
Budget Outcomes Under Three Scenarios

7. Annex 5 provides complete tabulation of the assumed rates of growth of services and the derived budgets by service category, fiscal years and three alternative scenarios. Annex 6 presents the same summary by organizational units (derived by mapping each service).

Medium-Term Budget Framework (FY89-91)

Aggregate Budgets

(in FY88 $ million)



Note: Post-reorganization baseline "Anchor" (to achieve presumed reorganization savings of $45.0 million)=736.5 million (in FY88 Dollars).

Contingencies

8. The framework provides contingencies amounting to 0%-2% of the budget depending on the scenario and budget year. The contingencies have also been 'front-loaded' to reflect the fact that the many uncertainties relating to the reorganization transition and the needs of the new structure of the Bank should be resolved by FY90/91.

Price Adjustments

9. Annex 4.4 provides our preliminary estimates of likely adjustments required to reflect price increases from FY88 to FY89 in the various expenditure categories. Overall, a price adjustment of the order of 5% to 6% seems to be indicated i.e., about a $37-$45 million increment would be required to convert the "real" budget presented in the framework into a FY89 nominal budget.

Capital Budget

10. Annex 4.5 provides our projections of required new capital budget authorizations. These projections exclude an expected major capital budget request for the proposed retrofit of the main buildings complex which would be presented to the Board separately for authorizations.

AG:eh
AG#15/technical

Medium-Term Budget Framework (FY89-91)
Lending, Supervision and Other Operational Work Programs

1. Lending commitments. Commitment assumptions at the high end of the range shown in the FY88 budget memorandum (FY91 is extrapolated) grow from $19.4 billion in FY88 to $25.2 billion in FY91. This is about 9% per year over the period, in real terms.1/ We assume fairly even growth in commitments across the four regions. Sub-Saharan Africa would receive 45% of IDA 8 resources as reflected in the FY88 Budget Memorandum. About half of the commitment increase would be "eaten up" by increased average size operations, so that the number of operations would only increase by about 4% per year. This would produce 265 operations in FY91, a major jump from the 225-235 projects realized in recent years. The number of projects would be expected to increase more in Africa and EMENA, and less in Asia, due to the limited options for increased size in the former two regions. In the case of LAC, large adjustment operations are offset to some extent by smaller sized projects (e.g. IDA projects in Haiti, Bolivia) in a number of the smaller borrowing countries. Hopefully, the more responsive structure of Operations will permit the authorization of a large number of projects in order to enhance the Bank's catalytic role. Commitment assumptions follow:

Medium-Term Framework: IBRD/IDA Commitment Assumptions

Region	FY88 Commitments (FY87 $b)	FY88 # Proj	FY91 Commitments (FY87 $b)	FY91 # Proj.	FYs 88-91 Growth Commitments (%)	FYs 88-91 Growth # Proj. (%)
Africa	3.3	75	4.3	86	9.2	4.7
Emena	4.3	47	5.5	53	8.6	4.1
LAC	4.6	47	5.9	55	8.7	5.4
Asia	7.3	68	9.5	71	9.2	1.5
Stet.	19.5	237	25.2	265	8.9	3.8

1/ Commitment deflators are under review.

2. Lending Work Variables. At the time of the FY88 Budget formulation PBD estimated a post-reorganization efficiency gain of about 7% from the base period (average of FY85 and FY86) which took into account loan officer redundancies in Operations' planned staff cutbacks and the lower completion coefficients expected as a result of the new loan processing procedures. The CAM shows an increase of 12 staffyears over PBD's original estimate which would lower the efficiency gain to about 5.4% in FY88. The medium-term scenario incorporates these 12 staffyears as a necessary increase for pipeline strengthening in FY88 and FY89. Further efficiency gains in lending work should occur throughout the planning period FY88-91. During the medium term all projects would fall under the new processing procedures. Projects under these procedures showed 15% lower completion coefficients in FY87 than projects brought to authorization under the old procedures. Moreover, the new organizational structure of Operations should result in closer interaction with borrowers and improved business planning, thereby reducing the staffyear "droppage factor". The scenario calculation implies an efficiency gain on the order of 9-9.5% by FY91 as compared to the pre-reorganization period are shown below. Since the FY88 budget was based on the achievement of a substantial share of these gains through specific reductions in redundancies, streamlining the projections for the outer years seems entirely feasible. These assumptions are retained in all three of the medium-term budget options.

LENDING WORK PARAMETERS

	Base* Period	FY88 Budget	FY88 CAM	FY89	FY90	FY91
Lending Staffyears	670	675	687	692	697	700
No. of Projects in 3-Year Horizon	699	758	758	787	797	802
SY per Project in 3-Year Horizon	0.96	0.89	0.91	.879	.875	.870
Efficiency Gain from Base Period						
Reduction in ratio	-	.07	.05	.081	.085	.09
Percentage change		- 7.0	- 5.4	- 8.1	-8.8	-9.3

* Average of FY85 and FY86

3. Lending Staffyears. These lending work parameters would mean 2.5% growth (17 SYs) from the currently distributed FY88 budget to FY89 and 0.5% growth (4-5 SYs per year) thereafter. The FY89 growth incorporates the revised FY88 CAM (12 SYs) plus an additional 5 SYs. We have used the same growth rates in each of the three scenarios (high, medium and low) on the assumption that the reorganization will produce substantial efficiencies in this aspect of the Bank's business. In other words, these

parameters should be targeted whatever "bottom-line" budget growth is ultimately decided.

4. Pipeline. The medium-term perspective assumes that at the level of lending resources indicated in the revised CAM, Operations will be able to overcome the pipeline weakness seen at the beginning of FY88. Thus, our plans assume that normal pipeline building efforts will characterize FY89 and beyond.

5. Supervision. The FY88 revised CAM showed about 10 staffyears less than the level needed to maintain the historic input-output relationship of 12 Staffweeks per project and about 20 SYs less than shown in the FY88 Budget Memorandum. This is understood as a temporary redeployment in a tight budget year, and supervision levels in the medium term should not reflect a permanent cut of this magnitude. We have therefore budgeted supervision at 12 staffweeks per project in FY89. At some point during the medium term, however, it should be possible to see efficiency improvements resulting from increased borrower participation in PCR preparation. A budget increase for OED was justified in FY88 to provide technical assistance to borrowers in PCR preparation, and savings in PCR staffyears should start showing up by FY89. To summarize, supervision increases are budgeted at 7 SYs in FY89 (as compared with the CAM), 4 SYs in FY90 and 4 SYs in FY91. This growth is the same in all three scenarios, on the assumption that "volume growth" requirements for supervision (as for lending) should be subject to efficiency gains at any and all levels of overall budgetary availability. The following table draws the medium-term implications for supervision requirements.

Supervision: Medium-Term Requirements

	Base Period*	FY88 Budget	FY88 CAM	FY89	FY90	FY91
Projects in 8 year Portfolio	1928	1921	1906	1918	1935	1958
SYs Total	479	494	472	480	484	488
Supervision	446	452	430	441	445	450
PCR-only	33	42	42	39	39	38
Staffweeks per Project	12	12.2	11.7	12	12	12
Staffweeks per PCR	8	10	10	9	9	8

* FY86-87.

6. Economic and Sector Work. One of the principal demands for budgetary resources during the medium term is expected to be for Economic and Sector work underpinning adjustment lending and poverty-oriented assistance. The CAM showed a big jump in ESW requirements -- about 44 SYs over PBD's original estimate. About 20 SYs against this requirement might be expected to come as part of PPR's 40 SYs of cross support to Operations. The pace at which the CAM-indicated increases are met and the need for growth beyond the resource levels in the CAM are major issues pertaining to ESW in the medium term. Option 1 assumes 3% growth in FY89 and 1.5% in FY89 and 90. Under this option Operations would reach its revised FY88 CAM level for ESW by FY90 and would operate during FY89 at a level of about 414 SYs, 8 less than in the CAM (we assume a continuing 20 SYs of PPR cross support). This option would require selective targeting of ESW and emphasis on high priority work. It may be a more difficult option for LAC and Africa where adjustment lending is a larger portion of total lending, though it would also pinch in other regions attempting to enhance the poverty alleviation impact of their programs. However, it takes account of staffing constraints and, with rigorous redeployment and effective ESW management it should be possible to meet highest priority requirements until the budget constraint can be relaxed somewhat in FY90-91.

7. Option 2 would meet the 422 SY requirement shown in the CAM by FY89 but provide no additional growth in that year. FY90 and FY91 would see very major growth in ESW -- on the order of 5% per year. Option 3 is even more expensive, with 5%, 7%, and 8% growth respectively in the years FY89-91. The following table summarizes the three options in relation to growth in commitments.

Economic & Sector Work

	FY88	FY91	Ave. annual % growth
Commitments (FY87 $b)	19.4	25.2	9.2
Adjustment Lending (FY87 $b)	4.8	6.3	9.2
ESW SYs			
Option 1	378 a/	428	4.2
Option 2	378	471	7.6
Option 3	378	496	9.5

a/ FY88 Budget Memorandum

8. Technical Assistance/Aid Coordination. The three main sources of growth in the medium term appear to be: 1) VP Financial Intermediation services; 2) Financial Technical Assistance; and 3) the regions. PBD's proposed framework for FY89 provides about 4 SYs of growth (3%) in the low option, 6 SYs (5%) in the medium option and 9 SYs (8%) in the high option recognizing that the Bank's "catalytic" role will depend on an expanded Bank effort in these areas. We would note, however, that Regions have in the past chosen to utilize additional resources justified for technical assistance/aid coordination in other work program (e.g. in the most recent CAM). While this may be justified in the short term, we would expect to see increased efforts reflected in the Operations' actuals usage, starting in FY89. Option 1 would essentially meet VP Financial Intermediation and Financial Technical Assistance needs, while Options 2 and 3 would provide 1-2 SYs of growth per region per year, primarily for enhanced aid coordination.

9. Field Offices. In formulating the medium-term perspective no special provision is made for field office creation or expansion. Under very tight budgetary conditions it must be an internal decision of Operations whether to deploy its work program resources in HQ or in the field. As in the past, incremental costs of field activities in this formulation would be met by the responsible managing units.

MEDIUM-TERM BUDGET FRAMEWORK (FY89-91)

ASSUMPTIONS: FINANCIAL WORK PROGRAMS

Financial Operations

Growth has been geared to the "high" scenario of the planning assumptions. In addition, the scenarios take account of the following factors: (a) the complexity factor driven by market conditions, back office support requirements, etc., and (b) the efficiency gains resulting from the reorganization and improvements in systems, as follows.

	FY88	FY89	FY90	FY91
A. Borrowing				
- Projections for Borrowing (FY88 $b)	11.0	11.3	11.6	11.9
- Factors for Growth Assumptions (%)				
• Volume Growth		2.7	2.7	2.6
• Complexity		2.0	2.0	2.0
• Efficiency/Increase in ave. size of borrowings		-1.0	-1.0	-2.0
Net Growth		3.7	3.7	2.6
- Administrative Expense Budget (FY88 $m) 1/	3.9	4.1	4.3	4.4
- Growth (FY88 $m)		0.2	0.2	0.1
B. Investments				
- Projections of Liquidity (FY88 $b)	18.4	17.9	16.7	17.4
- Factors for Growth Assumptions (%)				
• Volume Growth		-2.7	-6.7	+4.2
• Complexity		5.0	5.0	5.0
• Efficiency/Increase in average size of investment transactions		-2.0	-2.0	-2.0
Net Growth		+0.3	-3.7	+7.2
- Administrative Expense Budget (FY88 $m)	3.5	3.5	3.4	3.6
- Growth (FY88 $m)		-	-0.1	+0.2
C. Tokyo Office				
- Admin. Exp. Budget (FY88 $m)	1.2	1.2	1.3	1.3
- Growth (FY88 $m)		-	0.1	-
D. SVP. Finance/VP Treasurers				
- Adm. Exp. Budget (FY88 $m)	2.2	2.2	2.2	2.2
Total Adm. Exp. Budget for Financial Operations (FY88 $m)	10.8	11.0	11.2	11.5
Growth (FY88 $m)		0.2	0.2	0.3

1/ Discretionary & direct costs only.

Loan Administration

Growth in loan administration services has been projected based on the high assumptions for volume growth in disbursements for IDA and IBRD and for efficiency gains resulting from proposed restructuring of loan disbursement functions, as follows.

	FY88	FY89	FY90	FY91
- Projections of Disbmts (FY88 $b)	14.3	15.3	16.4	17.3
- Growth Assumptions (%):				
o Based on volume growth		7.0	7.2	5.5
o Offset for efficiency		-5.0	-5.0	3.0
o Net Growth		2.0	2.2	2.5
- Adm. Exp. Budget (FY88 $m)	7.1	7.3	7.5	7.7
- Growth (FY88 $m)		0.2	0.2	0.2

Financial Policy

Financial policy includes resource mobilization and risk analysis management work programs. Under Options I and II, it is proposed that the financial policy areas plough back all efficiency gains realized through the systems improvements to improve risk analysis and resource management. Under Option III, which permits a 2% growth each year over the medium-term, financial policy will receive a growth of about 1% in FY89 and 0.5% growth each in FY90 and FY91 to further expand advisory services to borrowers.

Financial Support

Financial support services include the Controller's (other than loan administration), Cashier's and the Pension Fund management programs. Under Option I, these programs would absorb a cut of about $0.5 million in FY89, $0.9 million in FY90 and $1.3 million in FY91 through efficiencies resulting from decentralization of transaction processing improvement in systems and "contracting out" arrangements for managing the pension funds. Option II calls for a zero reduction in these programs thereby allowing the unit management to use all efficiency gains to consolidate the management of these programs. Option III provides for a small growth ($0.3 million in FY89, $0.4 million in FY90 and $0.5 million in FY91) for these programs to provide flexibility to remain responsive to the needs of the environment in the 1990s and to firmly develop and establish a modern controllership function in the Bank. In addition, a one-time allocation in FY89 of about $1.0 million will be made to these programs to meet the post reorganization systems development needs.

Administration Complex

1. The resources allocated to the Administration Complex for Personnel, ITF and General Support Services are shown below.

Table 1: ADMINISTRATION COMPLEX
(in FY88 dollars)

		FY88 Distributed Budget	FY89	FY90	FY91
Scenario 1	amount ($m)	50.4	51.9	50.2	50.0
	% change		3.0	-3.3	-1.4
Scenario 2	amount ($m)	50.4	52.4	50.8	50.9
	% change		4.0	-3.1	0.2
Scenario 3	amount ($m)	50.4	53.0	51.3	52.1
			5.2	-2.8	1.2

2. Major efficiencies are expected following the reorganization in the area of personnel, ITF and general support services through decentralization of personnel management, payroll, benefits administration and accounts payable functions. Achieving the expected efficiences would, however, require significant investments in systems development. Precise amounts are yet to be estimated but $1.5-$2 million can be expected. 1/ Additional resources are also required to design and implement a new human resource strategy, and to strengthen the internal auditing function.

3. Some of the requirements listed above might be financed in FY88 through midyear redeployments and to that extent the requirements in the medium-term would be reduced. In FY89, the Administration Complex is being provided $1.5 million above the FY88 level of allocation, which should cover a large portion of the cost of new systems. But the Administration Complex will have to mobilize additional savings by attempting further efficiency or by cutting ongoing programs and reducing service standards. The amount of required savings would depend on the extent to which some of these requirements could be provided for at the FY88 midyear review, which budget scenario is accepted by the Policy Committee and how investments are phased out. The allocations for investment in systems have been deleted in FY90 and modest efficiency gains on account of systems has been assumed from FY91.

1/ Requirements for systems for decentralization of Payroll and Accounts Payable ($1 million) are covered in Attachment 4.2 for the Finance Complex.

4. Highlights of major programs within the Administration Complex in the medium-term are described below. Assuming that benefits, consultants and recruitment/employment functions are decentralized, major savings are expected in the Personnel area. In GSD, additional contracting out is envisaged in FY89 and FY90 and studies have been commissioned. Depending on the outcome of these studies, savings can be expected in GSD. In the area of Information and Technology, end user support services are to be decentralized. The appropriateness of the level of staffing in this area needs to be reviewed in light of the emerging demand from user units. Possible savings in the planning and strategy areas should also be considered. As regards Overheads, major savings can be expected in the Facilities area, particularly in the leasing of office space.

PRELIMINARY PRICE ASSUMPTIONS FOR FY89

PBD's initial projections of U.S. and overseas price increases, including the effects of dollar exchange fluctuations on the Bank's administrative expenses, indicate that an overall price allocation of 5-6% will be required for FY89. This is in line with a recently updated PAC forecast of U.S. inflation at 5.7% for FY89, and within the range of externally published forecasts (4.5-5.5%), although the price bases are not totally comparable due to factors such as foreign exchange, benefit entitlements, fixed overhead obligations and depreciation.

In estimating the Bank's aggregate price requirements, projections are first made for each of the Bank's expense accounts on the basis of selected indicators. These are presented in detail in the attached review of accounts, and summarized as follows:

FY89 Price Change Assumptions

Salaries:	5.0%	(Notional)
Other Staff Costs:	6.0%	(Mainly salary-driven)
Staff Travel:	10.0%	
Consultants:	5.0%	
Office Occupancy:	4.6%	
Communications:	2.4%	
Equipment:	-2.1%	
Field Office Expenses:	12.0%	(Average)

The relative importance of price change assumptions in the aggregate size of the budget is guaranteed to induce a concentrated focus on the reliability of these projections--as well as a renewed debate about principles which underlie the treatment of inflation in budget formulation and management. Therefore, views by Units regarding the methodology and the practice of inflation budgeting would be welcome.

BK:cmb/ah
(BK#1/annex4)

IBRD/IDA: ESTIMATED FY89 PRICE INCREASES

	Code	Account	ESTIMATED FY89 BASE BUDGET (FY88$)	PRICE FACTOR %	PRICE INCREMENT $	ESTIMATED FY89 BASE BUD (FY89$)	Basis for Price Estimation
		Staff Costs					
1	AA	Regular Salaries	260374	5.0	13019	273392	Effect of notional 5.5% increases eff. 5/88 and 5/89 less 0.5% dilution.
2	AB	Staff Retirement - IBRD	60220	5.0	3011	63231	Staff salary factor; assumes no change in Bank's contribution ratio.
3	AC	Dependency Tax Allow. - IBRD	11812	2.0	236	12049	Staff salary factor for variable component of benefit policy.
4	AE	Tax Reimbursements - IBRD	34031	0.0	0	34031	U.S. income tax allowance reduction on order of 10% (est. by Tax Office) negated by effects of [illegible] salary increase and possible increases in State income taxes.
5	AF	Temporary	13383	5.0	669	14052	Staff salary and agency factor.
6	AL	Local Staff Costs	5846	12.0	702	6548	Estimated average effect of local inflation and dollar exchange rates.
7	AG	Overtime	2149	5.0	107	2257	Staff salary factor less dilution.
8	AW	Termination - IBRD	15869	15.0	2380	18249	Estimated effect of salary factor including multiplier effect on prior year increments.
9	BA	Health Services	809	8.0	65	874	Current trend for health services as indicated in CPI Reports.
10	BB	Medical & Life Insurance	14974	8.0	1198	16172	Prediction of Insurance Officer & N.Y. Life Based on recent claims experience.
11	BD	Parking	-442	0.0	0	-442	Continuation of internal policy on basis of current rates.
12	BE	Staff Activities	221	4.0	9	230	Current trend for general services as indicated in CPI Reports.
13	BF	Staff Training	2189	8.0	175	2364	Current trend for educational services as indicated in CPI Reports.
14	BG	Education - Grants	8817	8.0	705	9522	Current trend for educational services as indicated in CPI Reports.
15	BH	Staff Dining	0	0.0	0	0	Continuation of internal policy to eliminate subsidy.
16	BM	Education - Travel	2377	10.0	238	2615	Forecast increases of 10% for air tickets (80%) and 10% for subsistence (20%).
		Post Allowances					
17	FA/FR		8777	6.0	527	9303	Estimated average effect of local inflation and dollar exchange rates for variable [illegible] of benefit.
		Other Travel					
18	TA	Resettlement	11628	7.7	895	12524	Forecast increases of 10% for air tickets and subsistence (50%) based on current [illegible] and 5.5% for overseas freight (50%).
19	TB	Home Leave	15511	10.0	1551	17062	Forecast increases of 10% for air tickets (80%) and 10% for subsistence (20%).
20	TC	Spouse Travel	1714	10.0	171	1885	Forecast increases of 10% for air tickets (60%) and 10% for subsistence (40%).
21	TG	Rest & Recuperation	500	10.0	50	550	Forecast increases of 10% for air tickets (50%) and 10% for subsistence (50%).
		Operational Travel					
22	CA	Staff Travel	69392	10.0	6939	76331	Forecast increases of 10% for air tickets (80%) and 10% for subsistence [illegible] based on [illegible] ICAO data.
		Representation					
23	DA	Representation	1780	5.0	89	1869	Trend for food services as indicated in CPI Reports.

	Object of Expenditure		ESTIMATED FY89 BASE BUDGET	PRICE FACTOR	PRICE INCREMENT	ESTIMATED FY89 BASE BUD	Basis for Price Estimation
	Code	Account	(FY88$)	%	$	(FY89$)	
		Staff Hospitality					
24	FB	Staff Hospitality	246	5.0	12	258	Trend for food services as indicated in CPI Reports.
		Consultants					
25	EA	Consultant Fees	54439	5.0	2722	57161	Forecast by Hewitt Association for executive/business salary price increases in [illegible].
		Contractual Services					
26	EE	Contractual Services	67590	7.1	4805	72395	For regular contractual services, current trend for general services as indicated in CPI Reports.
		of which:					For Special Programs, 8% based on estimate of requirements for [illegible] agencies.
		Reg. Contr. Serv.	20074	5.0	1004	21078	
		Contr. to Sp. Prog.	47516	8.0	3801	51317	
		HQ - Office Occupancy					
27	GA	Alterations & Maintenance	16682	5.5	918	17599	Current trends for building services and utilities as indicated in CPI and actual [illegible] contracts.
28	GE	Depreciation	7479	0.0	0	7479	No price increase by definition.
29	GC	Rents	17716	4.0	709	18425	Bank rental contracts basing increases on CPI and energy costs.
30	GD	Security	3633	5.5	200	3833	Current trend for specialized services as indicated in CPI Reports.
31	GK	Reimbursements	-4041	4.0	-162	-4203	Office occupancy average.
32	GL	Moving Expenses	853	5.5	47	900	Current trend for general services as indicated in CPI Reports.
33	GF	Furniture & Furnish. - Purch.	909	2.0	18	928	Current trend for furniture as indicated in CPI Reports.
34	GG	Furniture & Furnish. - Maint.	199	5.5	11	210	Current trend for specialized services as indicated in CPI Reports.
				4.0			
		Field - Office Occupancy					
		EAN	312	12.0	37	349	Estimated average effect of local inflation and dollar exchange requirements.
		WAN	614	12.0	74	687	
		EMENA	61	12.0	7	68	
		LAC	78	12.0	9	88	
		AEN	754	12.0	90	844	
		ASN	262	12.0	31	294	
		TOK	231	12.0	28	259	
		EUR	928	12.0	111	1039	
		SUB-TOTAL	3241	12.0	389	3630	
		SUB-TOTAL EXCLUDES EUROP.	2313	12.0	278	2591	
		Communications					
35	HA	Postage	2705	10.0	271	2976	Major rate increase due.
• 36	HB	Telephones	6000	0.0	0	6000	Current trend for communications services as indicated in CPI Reports.
37	HC	Cables	3204	0.0	0	3204	Current trend for communications services as indicated in CPI Reports.
38	HF	Telephone-Long Distance Calls	1281	0.0	0	1281	Forecast of continued decrease if not leveling of long distance rates.
39	HD	Freight	1500	5.5	83	1583	Current trend for specialized services as indicated in CPI Reports.
40	HE/KA-C	Other Field (Comms; Equip.)	3000	12.0	360	3360	Forecast of average local inflation and dollar exchange requirements.

Object of Expenditure			ESTIMATED FY89 BASE BUDGET	PRICE FACTOR	PRICE INCREMENT	ESTIMATED FY89 BASE BUD	Basis for Price Estimation
	Code	Account	(FY88$)	%	$	(FY89$)	
		HQ - Office Machines & Equipment - ITF Overhead					
41	KA	Purchase	769	0.0	0	769	Current trend for equipment as indicated in CPI Reports.
42	KB	Rental	2127	0.0	0	2127	Current trend for equipment as indicated in CPI Reports.
43	KC	Maintenance	1325	5.5	73	1398	Current trend for specialized services as indicated in CPI Reports.
44	KD	Office Mach. - Depreciation	1280	0.0	0	1280	No price increase by definition.
		HQ - Office Machines & Equipment - Computing					
45	KA	Purchase	5790	-10.0	-579	5211	Market trend of prior years.
46	KB	Rental	2929	-10.0	-293	2636	Market trend of prior years.
47	KC	Maintenance	1428	5.5	79	1507	Current trend for specialized services as indicated in CPI Reports.
48	KD	Office Mach. - Depreciation	3236	0.0	0	3236	No price increase by definition.
49	KS	Office Mach. - Software & Supp.					
		Supplies & Materials					
50	LA	General Supplies	2172	2.0	43	2216	Current trend for commodities & supplies as indicated in CPI Reports.
51	LB	Printing Supplies	2511	2.0	50	2561	Current trend for commodities & supplies as indicated in CPI Reports.
		Other Expenses					
52	MA	Library	3003	5.6	168	3172	Overall price factor for Bank assumed for IMF.
53	MB	Books & Periodicals	633	5.5	35	665	Current trend for books & periodicals as indicated in CPI Reports.
54	MC	Insurance	3300	8.0	264	3564	Forecast based on current trends for liability & general insurance.
55	MD	Other Miscellaneous Expenses	1000	4.5	45	1045	CPI forecast.
56	ME	Loss or Gain on Exchange	0	0.0	0	0	Averages zero over time; impossible to forecast with precision.
57	MF	Misc.-Field	508	12.0	61	569	Estimated average effect of local inflation and dollar exchange requirements.
58	VA	Contingency	18369	5.0	918	19287	Salary factor.
59	XA	Internal Computing Charge	0	0.0	0	0	
60	XB	Language Services Charge	0	0.0	0	0	
		Total before Reimb. & IFC fee	778949	5.6	43983	822932	
61	YA	Service & Support Fee	-3390	5.6	-190	-3580	Bank sub-total.
62	ZA	Reimbursements	-29545	5.6	-1655	-31200	Bank sub-total.
		TOTAL	746014	5.6	42138	788152	

Annex 4.4

Object of Expenditure — Code / Account	ESTIMATED FY89 BASE BUDGET (FY88$)	PRICE FACTOR %	PRICE INCREMENT $	ESTIMATED FY89 BASE BUD (FY89$)	Basis for Price Estimation
SUMMARIES:					
I. Salaries (1)	260374	5.0	13019	273392	
Other Staff Costs (2-21)	210386	6.0	12690	223076	
Other Discretionary Costs (22-26)	193446	7.5	14567	208014	
Office Occupancy (27-34)	46671	4.6	2129	48800	
Communications (35-39)	14690	2.4	353	15043	
Equipment (40-43, 45-47)	17368	-2.1	-360	17008	
Equipment Depreciation (44,48)	4516	0.0	0	4516	
Other Expenses (50-57)	13128	5.1	667	13795	
Contingency (58)	18369	5.0	918	19287	
TOTAL	778949 *	5.6	43983	822932	
II. Salaries (1)	260374	5.0	13019	273392	
Contingency (58)	18369	5.0	918	19287	
Salary-Driven (2-5/7-8)	137464	4.7	6404	143868	
Sub-total	416207	4.9	20341	436548	
Non-Salary Driven					
Staff Costs (6/9-21)	72922	8.6	6286	79208	
Other Costs (22-57) less Contr. to Sp. Prog	242304	5.6	13554	255858	
Sub-total	315226	6.3	19840	335066	
Total less Contr. to Sp. Prog.	731433	5.5	40181	771614	
Contr. to Special Programs	47516	8.0	3801	51317	
TOTAL	778949 *	5.6	43983	822932	

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* Before deducting reimbursements and IFC Service & Support Fee.

FY89 CAPITAL BUDGET PERSPECTIVE

1. The regular capital budget for FY89 (excluding retrofit) is expected to remain at the FY88 level of $22 million. Annual capital budgets should decrease slightly from this level in FY89-92, reflecting continuing price decreases in information technology equipment; and assuming, after the special project to be authorized to retrofit the Main Complex is underway, a continuing reduced level of investment in headquarters facilities through the regular capital budget. Although difficult to foresee with surety, this perpective also assumes that no additional investment will be required for large field office buildings (e.g., New Delhi) but provides for funding to continue occasional acquisition of small field office buildings when cost-effective to do so (e.g., Addis Ababa) and housing for headquarters-assigned staff.

2. In FY89, expenditures for automation are projected to decline by about $3 million, reflecting an extraordinary purchase of a $4.7 million mainframe computer in the FY88 capital budget, as well as continuing price decreases in PC's, and in general continuing restraint in the acquisition of new equipment as compared to FY85-87 levels. At the same time, expenditures for facilities are expected to increase by about $3 million net to cover $4 million in supplements for the Islamabad and New Delhi office building projects. These buildings, budgeted in FY85 at $4.1 and $3.0 million respectively, are now projected to cost $7.1 and $6.7 million, largely due to country difficulties resulting in delays during which the dollar has significantly decreased in value vis-a-vis European currencies in which many construction expenditures will be made. Recent reviews have indicated construction is still the most cost-effective option to meet the requirements of the resident missions, and work is proceeding on the buildings. The FY89 capital budget perspective also provides initial funding of $2 million for a Bank office building in Abuja in case this is required.

3. The FY87-88 Capital Programs and FY88-92 Perspective are summarized as follows:

Annual Capital Program Authorizations
($m)

	FY87	FY88	Perpective FY89	FY90	FY91	FY92
Automation Investment	10.9	13.3	10	12	12	10
Headquarters Facilities	10.7	6.8	6	6	7	7
Field Facilities	2.7	1.9	6	2	2	2
TOTAL	24.3	22.0	22	20	21	19

Retrofit

4. Planned retrofit of the Main Complex and "I" building is expected to be proposed to the Board in late February in a special authorization request (similar to the "J" Building capital budget), and is not covered in the regular capital budget request. Currently $1 million from previously authorized capital funding is being devoted to planning and design work for the retrofit, per Mr. Conable's note to the Board of March 23, 1987.

Medium Term Framework (FY89-91)

(Assumptions for Growth Rates of Services)

Service	Option 1 FY89 1/	Option 1 FY90	Option 1 FY91	Option 1 FY91 over FY88 per annum	Option 2 FY89 1/	Option 2 FY90	Option 2 FY91	Option 2 FY91 over FY88 per annum	Option 3 FY89 1/	Option 3 FY90	Option 3 FY91	Option 3 FY91 over FY88 per annum
A. Operating & Financial Services												
1. Lending	2.5%	0.5%	0.5%	1.2%	2.5%	0.5%	0.5%	1.2%	2.5%	0.5%	0.5%	1.2%
2. Supervision	1.0%	0.5%	0.5%	0.7%	1.0%	0.5%	0.5%	0.7%	1.0%	0.5%	0.5%	0.7%
3. Financial Operations	2.0%	2.0%	3.0%	2.3%	2.0%	2.0%	3.0%	2.3%	2.0%	2.0%	3.0%	2.3%
4. Loan Administration	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Subtotal	1.9%	0.6%	0.7%	1.1%	1.9%	0.6%	0.7%	1.1%	1.9%	0.6%	0.7%	1.1%
B. Advisory & Client Services												
5. Economic & Sector Work	3.0%	1.5%	1.5%	2.0%	4.0%	5.0%	6.0%	5.0%	5.0%	7.0%	8.0%	6.7%
6. Operational Policy & Review	0.0%	-1.0%	-1.0%	-0.7%	0.0%	1.0%	2.0%	1.0%	2.0%	3.0%	4.0%	3.0%
7. Training (EDI)	0.0%	0.0%	0.0%	0.0%	1.0%	2.0%	3.0%	2.0%	3.0%	4.0%	5.0%	4.0%
8. TA & Aid Coordination	3.0%	4.0%	4.0%	3.7%	5.0%	8.0%	11.0%	8.0%	8.0%	11.0%	14.0%	11.0%
9. Research	0.0%	0.0%	0.0%	0.0%	1.0%	2.0%	3.0%	2.0%	3.0%	4.0%	5.0%	4.0%
10. Public Information (Ext.Rel.)	0.0%	0.0%	0.0%	0.0%	0.5%	1.0%	1.5%	1.0%	2.0%	3.0%	4.0%	3.0%
11. Financial Tech. Assistance	1.0%	0.0%	0.0%	0.0%	1.0%	1.0%	1.0%	0.0%	2.0%	4.0%	6.0%	[illegible]
12. Special Grants	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.0%	2.0%	3.0%	[illegible]
Subtotal	1.2%	0.6%	0.6%	0.8%	1.8%	2.6%	3.5%	2.6%	3.7%	4.7%	5.9%	4.6%
C. Support Services												
13. Financial Support	4.0%	-4.0%	-0.5%	-0.2%	5.0%	-4.0%	0.0%	0.3%	6.0%	-4.0%	0.5%	0.8%
14. Financial Policy	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.0%	0.5%	0.5%	0.7%
15. Operational Planning	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.0%	0.5%	0.5%	0.7%
16. Operations Evaluation	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.0%	1.0%	1.0%	1.0%
17. Personnel, ITF & General Services	4.0%	-4.0%	-0.5%	-0.2%	5.0%	-4.0%	0.0%	0.3%	6.0%	-4.0%	0.5%	0.8%
18. Legal	0.0%	0.0%	0.0%	0.0%	1.0%	0.0%	0.0%	0.3%	1.0%	1.0%	1.0%	1.0%
19. Corporate Management	1.0%	-1.0%	0.0%	0.0%	2.0%	-1.0%	0.0%	0.3%	3.0%	-1.0%	1.0%	1.0%
Subtotal	2.3%	-2.3%	-0.3%	-0.1%	3.1%	-2.3%	0.0%	0.2%	4.1%	-2.2%	0.7%	0.8%
D. Overheads	0.0%	-0.5%	-0.5%	-0.3%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
E Benefits	1.7%	0.0%	0.4%	0.7%	2.1%	0.7%	1.7%	1.5%	2.9%	1.6%	2.8%	2.4%
F. Reimbursements	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

1/ FY89 growth rate is expressed with reference to the FY88 distributed budget base.

Medium Term Framework (FY89-91), Option I

(Summary of Programs Costs)

Service	FY88 Distributed Budget	Real FY89 Budget	% Growth Over FY88 a/	% Growth Over FY88 b/	Real FY90 Budget	% Growth Over FY89 a/	% Growth Over FY89 b/	Real FY91 Budget	% Growth Over FY90 a/	% Growth Over FY90 b/	Avg. Annual Growth Rate FY91 over FY88
	($m)	($m)	%	%	($m)	%	%	($m)	%	%	%
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
A. Operating & Financial Services											
1. Lending	107.1	109.8	2.5%	4.0%	110.3	0.5%	1.5%	110.9	0.5%	0.5%	1.2%
2. Supervision	76.6	77.4	1.0%	2.5%	77.8	0.5%	1.5%	78.1	0.5%	0.5%	0.7%
3. Financial Operations	10.8	11.0	2.0%	3.5%	11.2	2.0%	3.0%	11.6	3.0%	3.0%	2.3%
4. Loan Administration	7.1	7.2	2.0%	3.5%	7.4	2.0%	3.0%	7.5	2.0%	2.0%	2.0%
Subtotal	201.6	205.4	1.9%	3.4%	206.7	0.6%	1.6%	208.1	0.7%	0.7%	1.1%
B. Advisory & Client Services											
5. Economic & Sector Work	64.9	66.8	3.0%	4.5%	67.8	1.5%	2.5%	68.9	1.5%	1.5%	2.0%
6. Operational Policy & Review	35.2	35.2	0.0%	1.5%	34.8	-1.0%	0.0%	34.5	-1.0%	-1.0%	-0.7%
7. Training (EDI)	12.5	12.5	0.0%	1.5%	12.5	0.0%	1.0%	12.5	0.0%	0.0%	0.0%
8. TA & Aid Coordination	11.3	11.6	3.0%	4.5%	12.1	4.0%	5.0%	12.6	4.0%	4.0%	3.7%
9. Research	10.5	10.5	0.0%	1.5%	10.5	0.0%	1.0%	10.5	0.0%	0.0%	0.0%
10. Public Information (Ext.Rel.)	8.7	8.7	0.0%	1.5%	8.7	0.0%	1.0%	8.7	0.0%	0.0%	0.0%
11. Financial Tech. Assistance	0.0	0.1			0.1	0.0%	1.0%	0.1	0.0%	0.0%	
12. Special Grants	54.0	54.0	0.0%	1.5%	54.0	0.0%	1.0%	54.0	0.0%	0.0%	0.0%
Subtotal	197.1	199.5	1.2%	2.7%	200.6	0.5%	1.6%	201.8	0.6%	0.6%	0.8%
C. Support Services											
13. Financial Support	16.1	16.7	4.0%	5.5%	16.1	-4.0%	-3.0%	16.0	-0.5%	-0.5%	-0.2%
14. Financial Policy	3.3	3.3	0.0%	1.5%	3.3	0.0%	1.0%	3.3	0.0%	0.0%	0.0%
15. Operational Planning	10.2	10.2	0.0%	1.5%	10.2	0.0%	1.0%	10.2	0.0%	0.0%	0.0%
16. Operations Evaluation	5.0	5.0	0.0%	1.5%	5.0	0.0%	1.0%	5.0	0.0%	0.0%	0.0%
17. Personnel, ITF & General Services	40.6	42.2	4.0%	5.5%	40.5	-4.0%	-3.0%	40.3	-0.5%	-0.5%	-0.2%
18. Legal	7.9	7.9	0.0%	1.5%	7.9	0.0%	1.0%	7.9	0.0%	0.0%	0.0%
19. Corporate Management 1/	26.8	27.1	1.0%	2.5%	26.8	-1.0%	0.0%	26.8	0.0%	0.0%	0.0%
Subtotal	109.9	112.4	2.3%	3.8%	109.8	-2.3%	-1.4%	109.5	-0.3%	-0.3%	-0.1%
D. Total D & D Expenses (A+B+C)	508.6	517.3	1.7%	3.2%	517.1	0.0%	0.9%	519.4	0.4%	0.4%	0.7%
E. Overheads	71.5	71.5	0.0%	1.5%	71.1	-0.5%	0.5%	70.8	-0.5%	-0.5%	-0.3%
F. Benefits	172.1	175.1	1.7%	3.2%	174.9	-0.1%	0.9%	175.6	0.4%	0.4%	0.7%
G. Contingencies	17.6	11.5	n.a.	n.a.	7.6	n.a.	n.a.	0.0	n.a.	n.a.	n.a.
H. Salaries used to fund Reorg.	5.5	0.0	n.a.	n.a.	0.0	n.a.	n.a.	0.0	n.a.	n.a.	n.a.
I. Gross Adm. Budget (D+E+F+G+H)	775.3	775.3	0.0%	0.0%	770.8	-0.6%	-0.6%	765.8	-0.7%	-0.7%	-0.4%
J. Less Reimbursements	29.3	29.3	0.0%	0.0%	29.3	0.0%	0.0%	29.3	0.0%	0.0%	0.0%
K. Net Adm. Budget (I-J)	746.0	746.0	0.0%	0.0%	741.5	-0.6%	-0.6%	736.5	-0.7%	-0.7%	-0.4%

a/ Without distributing contingencies

b/ With contingencies assumed to be distributed on a pro-rata basis

1/ Budgets for Boards and Secretary's have been increased by $0.9 and 0.1 million in FY89 respectively. Budgets for Executive Offices, Ombudsman, Tribunal Internal Auditing have been protected at the FY88 distributed budget levels.

Medium Term Framework (FY89-91), Option 2

(Summary of Programs Costs)

Service	FY88 Distributed Budget	Real FY89 Budget	% Growth Over FY88 a/	% Growth Over FY88 b/	Real FY90 Budget	% Growth Over FY89 a/	% Growth Over FY89 b/	Real FY91 Budget	% Growth Over FY90 a/	% Growth Over FY90 b/	Avg. Annual Growth Rate FY91 over FY88
	($m)	($m)	%	%	($m)	%	%	($m)	%	%	%
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
A. Operating & Financial Services											
1. Lending	107.1	109.8	2.5%	4.5%	110.3	0.5%	2.0%	110.9	0.5%	1.0%	1.2%
2. Supervision	76.6	77.4	1.0%	3.0%	77.8	0.5%	2.0%	78.1	0.5%	1.0%	0.7%
3. Financial Operations	10.8	11.0	2.0%	4.0%	11.2	2.0%	3.5%	11.6	3.0%	3.5%	2.3%
4. Loan Administration	7.1	7.2	2.0%	4.0%	7.4	2.0%	3.5%	7.5	2.0%	2.5%	2.0%
Subtotal	201.6	205.4	1.9%	3.9%	206.7	0.6%	2.1%	208.1	0.7%	1.2%	1.1%
B. Advisory & Client Services											
5. Economic & Sector Work	64.9	67.5	4.0%	6.0%	70.9	5.0%	6.6%	75.1	6.0%	6.5%	5.0%
6. Operational Policy & Review	35.2	35.2	0.0%	2.0%	35.6	1.0%	2.5%	36.3	2.0%	2.5%	1.0%
7. Training (EDI)	12.5	12.6	1.0%	3.0%	12.9	2.0%	3.5%	13.3	3.0%	3.5%	2.0%
8. TA & Aid Coordination	11.3	11.9	5.0%	7.1%	12.8	8.0%	9.6%	14.2	11.0%	11.6%	8.0%
9. Research	10.5	10.6	1.0%	3.0%	10.8	2.0%	3.5%	11.1	3.0%	3.5%	2.0%
10. Public Information (Ext.Rel.)	8.7	8.7	0.5%	2.5%	8.8	1.0%	2.5%	9.0	1.5%	2.0%	1.0%
11. Financial Tech. Assistance	0.0	0.1			0.1	1.0%	2.5%	0.1	1.0%	1.5%	
12. Special Grants	54.0	54.0	0.0%	2.0%	54.0	0.0%	1.5%	54.0	0.0%	0.5%	0.0%
Subtotal	197.1	200.6	1.8%	3.8%	205.9	2.6%	4.1%	213.1	3.5%	4.0%	2.6%
C. Support Services											
13. Financial Support	16.1	16.9	5.0%	7.1%	16.2	-4.0%	-2.6%	16.2	0.0%	0.5%	0.3%
14. Financial Policy	3.3	3.3	0.0%	2.0%	3.3	0.0%	1.5%	3.3	0.0%	0.5%	0.0%
15. Operational Planning	10.2	10.2	0.0%	2.0%	10.2	0.0%	1.5%	10.2	0.0%	0.5%	0.0%
16. Operations Evaluation	5.0	5.0	0.0%	2.0%	5.0	0.0%	1.5%	5.0	0.0%	0.5%	0.0%
17. Personnel, ITF & General Services	40.6	42.6	5.0%	7.1%	40.9	-4.0%	-2.6%	40.9	0.0%	0.5%	0.3%
18. Legal	7.9	8.0	1.0%	3.0%	8.0	0.0%	1.5%	8.0	0.0%	0.5%	0.3%
19. Corporate Management	26.8	27.3	2.0%	4.0%	27.1	-1.0%	0.5%	27.1	0.0%	0.5%	0.3%
Subtotal	109.9	113.4	3.1%	5.2%	110.7	-2.3%	-0.9%	110.7	0.0%	0.5%	0.2%
D. Total D & D Expenses (A+B+C)	508.6	519.4	2.1%	4.1%	523.3	0.7%	2.2%	531.9	1.7%	2.2%	1.5%
E. Overheads	71.5	71.5	0.0%	2.0%	71.5	0.0%	1.5%	71.5	0.0%	0.5%	0.0%
F. Benefits	172.1	175.7	2.1%	4.1%	177.1	0.7%	2.2%	180.0	1.7%	2.2%	1.5%
G. Contingencies	17.6	15.3	n.a.	n.a.	11.6	n.a.	n.a.	3.9	n.a.	n.a.	n.a.
H. Salaries used to fund Reorg.	5.5	0.0	n.a.	n.a.	0.0	n.a.	n.a.	0.0	n.a.	n.a.	n.a.
I. Gross Adm. Budget (D+E+F+G+H)	775.3	782.0	0.9%	0.9%	783.4	0.2%	0.2%	787.3	0.5%	0.5%	0.5%
J. Less Reimbursements	29.3	29.3	0.0%	0.0%	29.3	0.0%	0.0%	29.3	0.0%	0.0%	0.0%
K. Net Adm. Budget (I-J)	746.0	752.7	0.9%	0.9%	754.1	0.2%	0.2%	758.0	0.5%	0.5%	0.5%

a/ Without distributing contingencies

b/ With contingencies assumed to be distributed on a pro-rata basis

1/ Budgets for Boards and Secretary's have been increased by $0.9 and 0.1 million in FY89 respectively. Budgets for Executive Offices, Ombudsman, Tribunal Internal Auditing have been protected at the FY88 distributed budget levels.

Medium Term Framework (FY89-91), Option 3

(Summary of Programs Costs)

Service	FY88 Distributed Budget ($m) (1)	Real FY89 Budget ($m) (2)	% Growth Over FY88 a/ % (3)	% Growth Over FY88 b/ % (4)	Real FY90 Budget ($m) (5)	% Growth Over FY89 a/ % (6)	% Growth Over FY89 b/ % (7)	Real FY91 Budget ($m) (8)	% Growth Over FY90 a/ % (9)	% Growth Over FY90 b/ % (10)	Avg. Annual Growth Rate FY91 over FY88 % (11)
A. Operating & Financial Services											
1. Lending	107.1	109.8	2.5%	4.5%	110.3	0.5%	2.0%	110.9	0.5%	1.5%	1.2%
2. Supervision	76.6	77.4	1.0%	3.0%	77.8	0.5%	2.0%	78.1	0.5%	1.5%	0.7%
3. Financial Operations	10.8	11.0	2.0%	4.0%	11.2	2.0%	3.5%	11.6	3.0%	4.0%	2.3%
4. Loan Administration	7.1	7.2	2.0%	4.0%	7.4	2.0%	3.5%	7.5	2.0%	3.0%	2.0%
Subtotal	201.6	205.4	1.9%	3.9%	206.7	0.6%	2.1%	208.1	0.7%	1.7%	1.1%
B. Advisory & Client Services											
5. Economic & Sector Work	64.9	68.1	5.0%	7.1%	72.9	7.0%	8.6%	78.7	8.0%	9.1%	6.7%
6. Operational Policy & Review	35.2	35.9	2.0%	4.0%	37.0	3.0%	4.5%	38.5	4.0%	5.0%	3.0%
7. Training (EDI)	12.5	12.9	3.0%	5.0%	13.4	4.0%	5.5%	14.1	5.0%	6.0%	4.0%
8. TA & Aid Coordination	11.3	12.2	8.0%	10.1%	13.5	11.0%	12.6%	15.4	14.0%	15.1%	11.0%
9. Research	10.5	10.8	3.0%	5.0%	11.2	4.0%	5.5%	11.8	5.0%	6.0%	4.0%
10. Public Information (Ext.Rel.)	8.7	8.9	2.0%	4.0%	9.1	3.0%	4.5%	9.5	4.0%	5.0%	3.0%
11. Financial Tech. Assistance	0.0	0.3			0.3	4.0%	5.5%	0.3	6.0%	7.0%	
12. Special Grants	54.0	54.5	1.0%	3.0%	55.6	2.0%	3.5%	57.3	3.0%	4.0%	2.0%
Subtotal	197.1	203.7	3.3%	5.4%	213.2	4.7%	6.2%	225.7	5.9%	6.9%	4.6%
C. Support Services											
13. Financial Support	16.1	17.1	6.0%	8.1%	16.4	-4.0%	-2.6%	16.5	0.5%	1.5%	0.8%
14. Financial Policy	3.3	3.3	1.0%	3.0%	3.3	0.5%	2.0%	3.4	0.5%	1.5%	0.7%
15. Operational Planning	10.2	10.3	1.0%	3.0%	10.4	0.5%	2.0%	10.4	0.5%	1.5%	0.7%
16. Operations Evaluation	5.0	5.1	1.0%	3.0%	5.1	1.0%	2.5%	5.2	1.0%	2.0%	1.0%
17. Personnel, ITF & General Services	40.6	43.0	6.0%	8.1%	41.3	-4.0%	-2.6%	41.5	0.5%	1.5%	0.8%
18. Legal	7.9	8.0	1.0%	3.0%	8.1	1.0%	2.5%	8.1	1.0%	2.0%	1.0%
19. Corporate Management	26.8	27.6	3.0%	5.0%	27.3	-1.0%	0.5%	27.6	1.0%	2.0%	1.0%
Subtotal	109.9	114.4	4.1%	6.1%	111.9	-2.2%	-0.7%	112.7	0.7%	1.7%	0.8%
D. Total D & D Expenses (A+B+C)	508.6	523.4	2.9%	4.9%	531.8	1.6%	3.1%	546.4	2.8%	3.8%	2.4%
E. Overheads	71.5	71.5	0.0%	2.0%	71.5	0.0%	1.5%	71.5	0.0%	1.0%	0.0%
F. Benefits	172.1	177.1	2.9%	4.9%	179.9	1.6%	3.1%	184.9	2.8%	3.8%	2.4%
G. Contingencies	17.6	15.4	n.a.	n.a.	11.7	n.a.	n.a.	8.0	n.a.	n.a.	n.a.
H. Salaries used to fund Reorg.	5.5	0.0	n.a.	n.a.	0.0	n.a.	n.a.	0.0	n.a.	n.a.	n.a.
I. Gross Adm. Budget (D+E+F+G+H)	775.3	787.5	1.6%	1.6%	794.9	0.9%	0.9%	810.9	2.0%	2.0%	1.5%
J. Less Reimbursements	29.3	29.3	0.0%	0.0%	29.3	0.0%	0.0%	29.3	0.0%	0.0%	0.0%
K. Net Adm. Budget (I-J)	746.0	758.2	1.6%	1.6%	765.6	1.0%	1.0%	781.6	2.1%	2.1%	1.6%

a/ Without distributing contingencies

b/ With contingencies assumed to be distributed on a pro-rata basis

1/ Budgets for Boards and Secretary's have been increased by $0.9 and 0.1 million in FY89 respectively. Budgets for Executive Offices, Ombudsman, Tribunal Internal Auditing have been protected at the FY88 distributed budget levels.

Medium Term Framework (FY89-91)

(Resulting Growth Rates of Units Budgets)

	FY88 Distributed Budget ($m)	Option 1				Option 2				Option 3			
		FY89	FY90	FY91	FY91 over FY88 per annum	FY89	FY90	FY91	FY91 over FY88 per annum	FY89	FY90	FY91	FY91 over FY88 per annum
1. Boards	14.5	6.2%	0.0%	0.0%	2.0%	6.2%	0.0%	0.0%	2.0%	6.2%	0.0%	0.0%	2.0%
2. Secretary's	2.9	3.4%	0.0%	0.0%	1.1%	3.4%	0.0%	0.0%	1.1%	3.4%	0.0%	0.0%	1.1%
3. Executive Offices	0.9	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
4. PPR	67.9	-0.9%	-0.6%	-0.1%	-0.5%	-0.1%	1.3%	2.5%	1.2%	1.9%	3.0%	4.6%	3.2%
5. Operations	266.8	2.1%	0.8%	0.8%	1.2%	2.4%	1.8%	2.2%	2.2%	2.8%	2.5%	3.0%	2.8%
6. Finance	37.3	2.9%	-0.8%	1.0%	1.0%	3.5%	-0.8%	1.0%	1.2%	4.6%	-0.8%	1.5%	1.7%
7. Administration	50.4	3.0%	-3.3%	-0.4%	-0.3%	4.0%	-3.1%	0.2%	0.3%	5.2%	-2.8%	1.2%	1.1%
8. Legal	7.9	0.0%	0.0%	0.0%	0.0%	1.3%	0.0%	0.0%	0.1%	1.3%	1.3%	0.0%	0.8%
9. OED	5.0	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	2.0%	0.0%	2.0%	1.3%
10. Other	1.0	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
11. Special Programs	54.0	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.9%	2.0%	3.1%	2.0%
12. Total Direct & Discretionary	508.7	1.7%	0.0%	0.4%	0.7%	2.1%	0.8%	1.6%	1.5%	2.9%	1.6%	2.7%	2.4%
13. Overheads	71.5	0.0%	-0.6%	-0.4%	-0.4%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
14. Benefits	172.1	1.7%	-0.1%	0.4%	0.7%	2.1%	0.8%	1.6%	1.5%	2.9%	1.6%	2.8%	2.4%
15. Contingencies	23.0												
16. Total Adm. Expenses	775.3	0.0%	-0.6%	-0.6%	-0.4%	0.9%	0.2%	0.5%	0.5%	1.6%	0.9%	2.0%	1.5%
17. Less Reimbursements	29.3	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
18. Total Adm. Budget	746.0	0.0%	-0.6%	-0.7%	-0.4%	0.9%	0.2%	0.5%	0.5%	1.6%	1.0%	2.1%	1.6%

Medium Term Framework (FY89-91), Option 1

(Summary of Resulting Units Costs)

Annex 6
Page 2

	FY88 Distributed Budget ($m)	FY89 ($m)	FY89 (%)	FY90 ($m)	FY90 (%)	FY91 ($m)	FY91 (%)	Avg. Annual Growth Rate FY91 over FY88 %
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1. Boards	14.5	15.4	6.2	15.4	0.0	15.4	0.0	2.0%
2. Secretary's	2.9	3.0	3.4	3.0	0.0	3.0	0.0	1.1%
3. Executive Offices	0.9	0.9	0.0	0.9	0.0	0.9	0.0	0.0%
4. PPR	67.9	67.3	-0.9	66.9	-0.6	66.8	-0.1	-0.5%
5. Operations	266.8	272.5	2.1	274.7	0.8	276.9	0.8	1.2%
6. Finance	37.3	38.4	2.9	38.1	-0.8	38.5	1.0	1.0%
7. Administration	50.4	51.9	3.0	50.2	-3.3	50.0	-0.4	-0.3%
8. Legal	7.9	7.9	0.0	7.9	0.0	7.9	0.0	0.0%
9. OED	5.0	5.0	0.0	5.0	0.0	5.0	0.0	0.0%
10. Other	1.0	1.0	0.0	1.0	0.0	1.0	0.0	0.0%
11. Special Programs	54.0	54.0	0.0	54.0	0.0	54.0	0.0	0.0%
12. Total Direct & Discretionary	508.7	517.3	1.7	517.1	0.0	519.4	0.4	0.7%
13. Overheads	71.5	71.5	0.0	71.1	-0.6	70.8	-0.4	-0.4%
14. Benefits	172.1	175.1	1.7	174.9	-0.1	175.6	0.4	0.7%
15. Contingencies	23.0	11.5	n.a.	7.6	n.a.	0.0	n.a.	n.a.
16. Total Adm. Expenses	775.3	775.3	0.0	770.8	-0.6	765.8	-0.6	-0.4%
17. Less Reimbursements	29.3	29.3	0.0	29.3	0.0	29.3	0.0	0.0%
18. Total Adm. Budget	746.0	746.0	0.0	741.5	-0.6	736.5	-0.7	-0.4%

Medium Term Framework (FY89-91), Option 2

(Summary of Resulting Units Costs)

	FY88 Distributed Budget ($m)	FY89 ($m)	FY89 (%)	FY90 ($m)	FY90 (%)	FY91 ($m)	FY91 (%)	Avg. Annual Growth Rate FY91 over FY88 %
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1. Boards	14.5	15.4	6.2	15.4	0.0	15.4	0.0	2.0%
2. Secretary's	2.9	3.0	3.4	3.0	0.0	3.0	0.0	1.1%
3. Executive Offices	0.9	0.9	0.0	0.9	0.0	0.9	0.0	0.0%
4. PPR	67.9	67.8	-0.1	68.7	1.3	70.4	2.5	1.2%
5. Operations	266.8	273.3	2.4	278.3	1.8	284.5	2.2	2.2%
6. Finance	37.3	38.6	3.5	38.3	-0.8	38.7	1.0	1.2%
7. Administration	50.4	52.4	4.0	50.8	-3.1	50.9	0.2	0.3%
8. Legal	7.9	8.0	1.3	8.0	0.0	8.0	0.0	0.1%
9. OED	5.0	5.0	0.0	5.0	0.0	5.0	0.0	0.0%
10. Other	1.0	1.0	0.0	1.0	0.0	1.0	0.0	0.0%
11. Special Programs	54.0	54.0	0.0	54.0	0.0	54.0	0.0	0.0%
12. Total Direct & Discretionary	508.7	519.4	2.1	523.3	0.8	531.9	1.6	1.5%
13. Overheads	71.5	71.5	0.0	71.5	0.0	71.5	0.0	0.0%
14. Benefits	172.1	175.7	2.1	177.1	0.8	180.0	1.6	1.5%
15. Contingencies	23.0	15.3	n.a.	11.6	n.a.	3.9	n.a.	n.a.
16. Total Adm. Expenses	775.3	782.0	0.9	783.4	0.2	787.3	0.5	0.5%
17. Less Reimbursements	29.3	29.3	0.0	29.3	0.0	29.3	0.0	0.0%
18. Total Adm. Budget	746.0	752.7	0.9	754.1	0.2	758.0	0.5	0.5%

Medium Term Framework (FY89-91), Option 3

(Summary of Resulting Units Costs)

	FY88 Distributed Budget ($m) (1)	FY89 ($m) (2)	FY89 (%) (3)	FY90 ($m) (4)	FY90 (%) (5)	FY91 ($m) (6)	FY91 (%) (7)	Avg. Annual Growth Rate FY91 over FY88 % (8)
1. Boards	14.5	15.4	6.2	15.4	0.0	15.4	0.0	2.0%
2. Secretary's	2.9	3.0	3.4	3.0	0.0	3.0	0.0	1.1%
3. Executive Offices	0.9	0.9	0.0	0.9	0.0	0.9	0.0	0.0%
4. PPR	67.9	69.2	1.9	71.3	3.0	74.6	4.6	3.2%
5. Operations	265.8	274.4	2.8	281.2	2.5	289.6	3.0	2.8%
6. Finance	37.3	39.0	4.6	38.7	-0.8	39.3	1.6	1.7%
7. Administration	50.4	53.0	5.2	51.5	-2.8	52.1	1.2	1.1%
8. Legal	7.9	8.0	1.3	8.1	1.3	8.1	0.0	0.8%
9. OED	5.0	5.1	2.0	5.1	0.0	5.2	2.0	1.3%
10. Other	1.0	1.0	0.0	1.0	0.0	1.0	0.0	0.0%
11. Special Programs	54.0	54.5	0.9	55.6	2.0	57.3	3.1	2.0%
12. Total Direct & Discretionary	508.7	523.4	2.9	531.8	1.6	546.4	2.7	2.4%
13. Overheads	71.5	71.5	0.0	71.5	0.0	71.5	0.0	0.0%
14. Benefits	172.1	177.1	2.9	179.9	1.6	184.9	2.8	2.4%
15. Contingencies	23.0	15.4	n.a.	11.7	n.a.	8.0	n.a.	n.a.
16. Total Adm. Expenses	775.3	787.5	1.6	794.9	0.9	810.9	2.0	1.5%
17. Less Reimbursements	29.3	29.3	0.0	29.3	0.0	29.3	0.0	0.0%
18. Total Adm. Budget	746.0	758.2	1.6	765.6	1.0	781.6	2.1	1.6%

DRAFT
FRS
December 9, 1987

MEMORANDUM TO THE EXECUTIVE DIRECTORS

SUBJECT: Review of IBRD Liquidity Policy

Section I. Introduction

1. This paper reviews the Bank's liquidity policy and the actual levels of liquid holdings in relation to the guidelines approved by the Board in May 1983 [1]. At that time, the Executive Directors re-confirmed the then existing policy that annual borrowings should be planned so as to achieve year-end liquid holdings not less than 40% of the next three years' net cash requirements (the "three-year NCR") [2] suitably adapted to include the then-new short-term borrowings. Directors also approved an explicit range for liquid holdings up to 45% of the three-year NCR. The purpose of the range was to permit the Bank to take advantage of favourable borrowing opportunities.

2. During the four and a half years since the last policy review, planned levels of liquid holdings have -- with the notable exception of FY87 -- been consistent with the established range, but the actual level of liquidity has more often than not turned out to be higher than planned. The difference was especially large at the end of FY86, when the ratio of actual liquidity to projected three-year NCR reached 50%. The upward drift in the ratio could have been corrected by an offsetting reduction in Bank borrowings below planned levels, but this would have meant disrupting market r^lationships and foregoing borrowing opportunities that were very attractive with respect to both interest rate and maturity. Management recommended -- and the Board agreed -- to allow the liquidity ratio to remain temporarily above the established policy range, pending a review of that policy.

3. The memorandum is divided into three major sections:

- Section II summarizes the evolution of IBRD liquidity policy and selected aspects of the Bank's financial development since the last review of liquidity policy. It shows that considerations of funding strategy and unforeseen shortfalls in gross disbursements were the principal reasons why the level of liquidity has been high in recent years.

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[1] "Review of IBRD Liquidity Policy" (R83-101, dated April 14, 1983).

[2] Definition of the Three-year NCR. The next three years' net cash requirements equals gross disbursements plus outstanding debt due to mature, less repayments and sales of loans, less net income adjusted for non-cash items, less the increase in usable capital, with all items projected over the three years following the year in question. Short-term debt (including discount notes, the central bank facility, and the two-year central bank offerings) is deemed to mature once, but only once, during the three-year period.

- Section III reviews the objectives of liquidity policy in light of the various factors which could lead to a serious shortfall in actual Bank borrowings in the years ahead. It concludes that a moderate increase in the minimum planned level of year-end liquidity, to 45% of the three-year NCR, would be prudent in view of the increased risks that could lead to temporary impairment of the Bank's borrowing capacity at some point in the next few years.

- Section IV argues that there are good reasons to hold discretionary liquidity above the prudential minimum level. These reasons derive from considerations of funding strategy as well as a pragmatic recognition of the problems in accurately predicting the level of liquidity and the three-year NCR. Criteria that would be applied to justify any significant volume of discretionary liquidity are proposed. Consequently, it is recommended that liquidity policy should continue to be operated in a flexible manner based on the specified percentage guideline for the prudential minimum.

Section II. Evolution of Bank Liquidity Policy and Practice

4. Evolution of Policy. In the early years of the Bank, when it was still establishing itself as a major borrower in financial markets, it followed a policy of "fully funding" its commitments. "Full funding" meant that the Bank did not commit itself to provide funds to borrowers under loan contracts unless it at once acquired -- through borrowings, capital subscriptions or retained earnings -- the funds needed to meet those commitments in full. This was a very conservative form of liquidity policy, since it enabled the Bank to avoid any dependence whatever on future borrowings to meet its contractual commitments. At the end of FY52, it was decided that funds available for lending should not be reduced below one year's estimated loan disbursements. In practical terms, however, apart from a brief dip below full funding in FY55-FY57, the Bank maintained its initial approach until well into the 1960s. (Fiscal year figures are shown in Attachment I). By that time the Bank had matured as a borrower and could prudently begin to rely on its ability to tap markets in the future as backing for its loan commitments. This began to happen gradually during the latter part of the 1960s. The absolute level of liquid holdings was maintained at about $1.5 billion between FY64 and FY68, equivalent to about two years' of projected disbursements. This implied a degree of "partial funding" (i.e. reliance on future borrowings to meet commitments). But because Bank commitments were relatively stable during this period, this dependence was not seen as a cause for concern.

5. It was not until the early 1970s, under the pressure of increasing commitments and disbursements, that the first formal review of Bank liquidity policy took place. That review [3], completed in 1971, related the desired level of liquid holdings to the uncertainties the Bank faced in its borrowings. The measure of the uncertainties in borrowings was refined in the policy review of 1973 [4], with the introduction of the concept of the Bank's cash flow excluding borrowings (i.e. the three-year NCR).The review of 1973 explicitly recognized that the appropriate level of liquid assets requires a balancing of two conflicting objectives. On the one hand, the objective of minimizing dependence on future borrowings is best served by maintaining a high level of liquid holdings. On the other hand, a high level of liquid holdings could expose the Bank and its borrowers to a "cost of carry" if returns on short-term investments turn out to be below the cost of borrowed funds.

6. The policy proposed in 1973 -- that is, to maintain liquid holdings at 40% of the three-year NCR -- was seen as a pragmatic compromise. Excessive dependence on future borrowings would be avoided by maintaining liquidity equal to 40% of the next three years' cash requirements, irrespective of net income considerations. Higher levels of liquidity were not ruled out, but they would require special justification. Two types of justification were envisaged. One was based on the desirability of

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[3] "Bank Liquidity Policy" (R71-64, dated March 31, 1971).

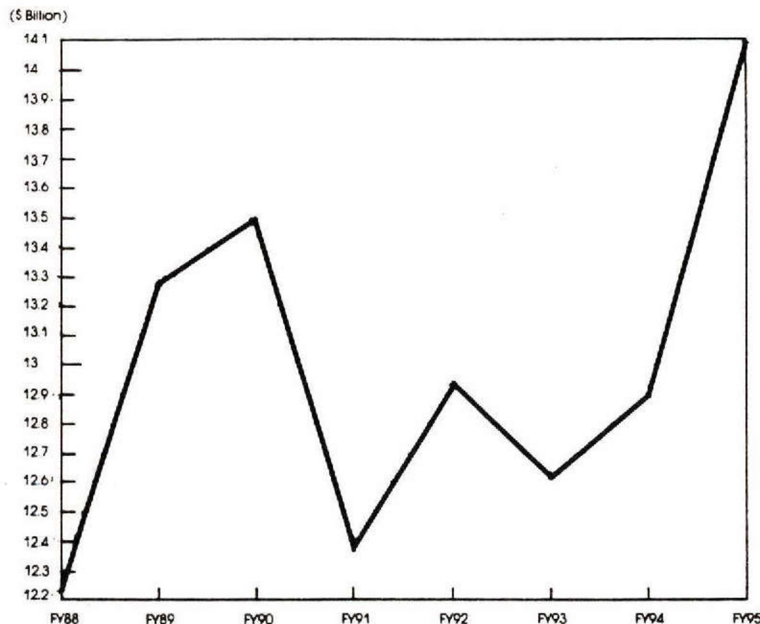
[4] "Review of IBRD Financial Policies" (R73-55, dated March 28, 1973).

maintaining an orderly progression in the levels of annual borrowing. Liquidity could rise above 40% if this were needed in order to smooth out anticipated abrupt increases during forthcoming years in the annual level of borrowing. The second way in which higher levels of liquidity could be justified would be by showing that the market opportunities for borrowing and investment were such that net income would not suffer.

7. The rapid growth in the absolute level of liquid holdings during the latter half of the 1970s led to re-examination, in the review of 1983, of the Bank's need to hold liquidity. It was argued that the level of liquidity should not to be viewed as a discretionary item that can be reduced at little or no cost or risk to the Bank. To the contrary, liquid holdings should be understood as contributing a vital element of flexibility to the Bank's funding strategy, because the Bank faces large contractual obligations to provide funds, both to meet disbursements under loans and to repay borrowings made in the past. A portion of these contractual obligations will be covered by repayments received from borrowers and other internally generated funds. But the bulk will have to be borrowed. One way of measuring the size of the Bank's funding exposure is to look at the annual contractual outflow, which is defined as the excess of loan disbursements plus debt retirement over repayments of loans. Chart 1 illustrates the magnitude of the Banks net contractual obligations in each of the next several years.

Chart 1

Projected Contractual Net Outflows



8. Because these obligations are contractual, the issue is not whether to borrow, but when. The greater the uncertainty about the Bank's ability to borrow funds in the future on appropriate terms, the greater should be the fraction of the Bank's contractual commitments that it raises in advance (and holds in the form of liquid assets). Liquidity policy is thus essentially a matter of how contractually-driven borrowings will be phased over time. A higher level of liquidity means that the Bank has correspondingly reduced its dependence on future market conditions.

9. The 1983 policy review acknowledged that the degree of such protection required by the Bank was ultimately a matter of judgement. To assist in forming a judgment, the review presented a series of scenarios in which the Bank's borrowings were assumed to be interrupted. The consequences for the level of liquid holdings were then projected under different assumptions about the starting level of liquidity. With a starting level equivalent to 40% of the three-year NCR, the absolute level of liquid holdings was seen to bottom out at a figure which was thought likely to be tolerable by the financial markets. Accordingly, Management recommended -- and the Board agreed -- to retain the 40% figure as the minimum planning objective.

10. The 1983 review also pointed out that levels of liquidity higher than called for under the 40% formula could be justified under favourable market conditions and urged that a margin of discretion be allowed up to 45% to permit Management to take advantage of such opportunities. This too was agreed by the Executive Directors, although it was expected that actual liquidity would be targeted at about 42.5% unless good reasons were put forward for an alternative figure. The policy indicators and practice of other multilateral development banks are summarized in Attachment II.

1'. <u>Liquidity In Practice</u>. The implementation of liquidity policy over the past decade is summarized in Table 1. The chief considerations which have prevailed are that the level of liquidity should lie above the prudential minimum, that the year-to-year variations in the borrowing programs should be reasonably smooth, and that the size of the borrowing program should reflect anticipated market conditions. The interplay of these factors can be seen in the table. It is noticeable that the planned levels of liquidity have been <u>increased</u> when the alternative would have been an accentuated drop in the borrowing program from the previous year's level; and <u>decreased</u> when the borrowing program was planned to rise. For example, the level of liquidity was deliberately planned to be high in FY79 and FY87, in order to avoid an excessively sharp drop from the preceding year in the borrowing program. A rigid adherence to a fixed liquidity ratio would have led to wider variation in the borrowing program than shown in Table 1. For the FY88 financial program, it was argued that "...a higher-than-customary level of liquidity can be justified in terms of sound financial management because of the favorable market opportunities now available in Japanese yen and a few other currencies"[5]. Conversely, poor market conditions were responsible for a planned reduction in liquidity to slightly below the prudential minimum in FY82 and FY83.

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[5] FY88 Review of Financial and Operating Programs, para. 3.09.

Table 1: Planned Liquidity and Borrowing Programs
(all figures represent programs approved at the beginning of each fiscal year)

Fiscal year	78	79	80	81	82	83	84	85	86	87	88
Liquidity (as % of projected 3-year NCR)	46	51	43	40	39	39	45	43	42	50	47
Borrowing ($ Bn)	4.6	4.3	5.3	6.6	7.1	9.1	10.2	11.9	9.5	9.0	11.0

12. The actual levels of liqudity have, however, differed from the planned levels due to errors in forecasting key components of cash flow. As shown in Table 2, liquidity was higher than planned in FY85 and FY86 because net disbursements turned out to be lower than projected; in FY87, the reverse was true. The projection errors in net disbursements (i.e., the projected value less the actual outcome) are shown in the table, and the last two lines show what liquidity would have been ("adjusted liquidity") if the projections had been perfect. The bottom line of the table thus shows that generally (excepting FY87) liquidity guidelines were exceeded because of errors in forecasting net disbursements.

Table 2: The Level of Liquidity: FY83-FY87
($ Million)

	FY83	FY84	FY85	FY86	FY87
Cash & Investments (Actual, end FY)	13196	14869	17360	20014	18802
Planned Liquidity Level (%)	39%	45%	43%	42%	50%
Actual Liquidity Level (%)	43%	41%	45%	50%	48%
Net Disbursements (Actual)	4794	6127	5894	4226	5316
Projection Error for Net Disbursements	+432	-292	+906	+1951	-1126
Adjusted Cash & Invts.	12764	15161	16454	18063	19928
Adjusted Liquidity Level (%)	42%	42%	42%	45%	51%

Note: (1) The planned and actual levels of liquidity equal respectively, planned and actual cash and investments expressed as a percentage of the projected three-year NCR.
(2) The projection error for net disbursements equals projected net disbursements at the start of the fiscal year less actual net disbursements.
(3) Adjusted cash and investments equals actual cash and investments adjusted by subtracting the projection error for net disbursements.

13. There are two major sources of errors in forecasting the Bank's cash flows: disbursements on adjustment loans and movements in foreign exchange rates. The timing of disbursements on adjustment loans is inherently hard to predict and their scale has expanded sharply from $95 million in FY79, to $871 million in FY83, and $3.2 billion in FY87. Their share of total disbursements has grown to 28% in FY87. Exchange rate fluctuations, the other basic source of forecasting error, affect liquidity mainly as they affect the dollar equivalent of loan repayments, debt retirements, and the value of investments itself. Because of currency fluctuations, the error in forecasting loans repayments in FY87, for example, exceeded $1 billion equivalent. Fortunately, the effect of exchange rates on debt retirement and loan repayments tend to offset each other as far as net cash flows are concerned, but nonetheless there remains a significant residual volatility.

14. The sizeable departures from established liquidity policy -- both in terms of planned and actual liquidity levels -- have naturally led to calls for a review both of the policy itself and of the way in which the policy is applied in practice. The remaining sections of this memorandum take up these issues, focussing first on the factors that affect the adequacy of the 40% guideline, which has been regarded as the minimum prudent objective in recent years.

Section III. The Prudent Minimum Level of Liquidity

The Adequacy of Liquidity and Current Financial Risks

15. The principal objective of liquidity policy is to guard against the possibility of unforeseen variations in the Bank's cash flows, the most important of which is the possibility of an interruption in borrowings. The typical magnitudes of IBRD cash flows are illustrated in Table 3, which shows that the dominant items are loan repayments, debt retirements, disbursements, and borrowings. The first three of these are mostly outside the Bank's immediate control and are subject to variation due to several causes, as discussed earlier (paragraph 13). Thus, imbalances in these flows must be met by compensating variations either in borrowings or in liquid holdings.

Table 3: IBRD Cash Flow Summary FY87

	($Million)	(%)
Net Income	1113	7
Repayments & Sales of Loans	6087	35
Borrowings	9514	55
New Usable Capital	506	3
TOTAL SOURCES	17220	100
Disbursements:	11403	62
(Adjustment Lending)	(3232)	
(Other)	(8171)	
Debt Retirement	7837	42
Other	- 808	- 4
TOTAL APPLICATIONS	18432	100
DECREASE IN LIQUIDITY	1212	

Note: (1) "Other" applications includes net currency translation adjustments and non-cash items in net income.
(2) Borrowings and Debt Retirement exclude re-financing of short-term debt.

16. Since the basic purpose of liquidity is to act as a buffer against shortfalls in borrowings, a review of the adequacy of liquidity needs to take account of three parameters: first, the risk of shortfalls in borrowings which the Bank might plausibly be expected to face at some point in the next few years; second, the ability of the Bank to reduce funding requirements, which effectively means (aside from reductions in liquidity) its ability and willingness to curtail loan commitments and disbursements; and third, the "critical threshold" level of liquidity, below which the Bank might not be able to sustain market confidence.

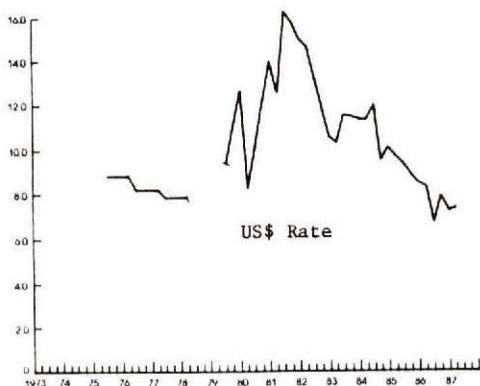
17. _Risk of Shortfalls_. Past analysis of Bank liquidity needs has recognized several threats to the availability of borrowed funds. One risk is that the Bank's access to borrowed funds may be temporarily impaired; another is that market conditions will deteriorate to the point where the Bank (along with other potential borrowers) cannot raise funds on reasonable terms; a third is that investors' confidence in the Bank may be shaken by some adverse development, making it advisable for the Bank to scale back its borrowing until confidence can be restored.

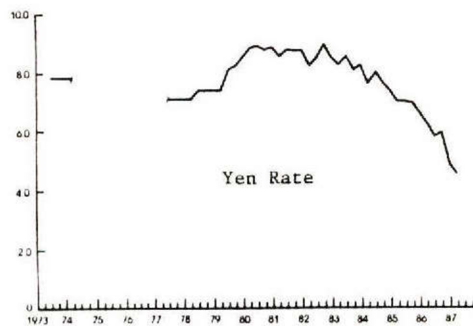
18. The first of these risks figured rather prominently in earlier reviews, reflecting the Bank's actual experience at various times in the 1970s. The increasing integration of international financial markets has made it more difficult for authorities to regard their own markets as separate and distinct sources of funding that can be insulated from other markets; nevertheless that integration itself has facilitated volatile capital flows into and out of foreign exchange and money markets, which could encourage authorities to reintroduce restrictions. Presently, limits on access are utilized principally to ensure orderly market conditions. Hence, on balance, this particular risk looms less large today than it did a few years ago.

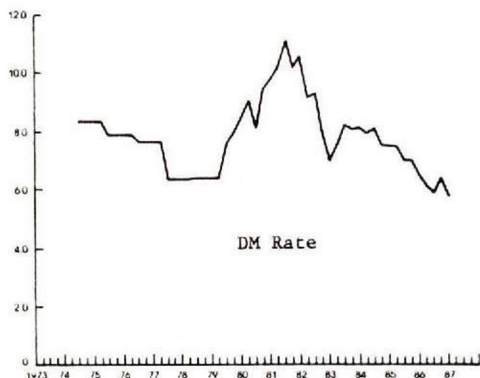
19. The risk of adverse general market conditions cannot be so easily disposed of. The Bank, along with other fixed-rate borrowers, has benefited from the significant expansion in capital market activity that has occurred over the past five years. Chart 2 illustrates the trend of borrowing costs since the early 1970s in each of the Bank's four major borrowing currencies. By the end of calendar 1986, rates for new Bank borrowing were at or close to their low points for the past thirteen years. The conclusion to be drawn is not that interest rates are likely to rise (although they might); rather it is that borrowing conditions have been exceptionally favourable over the past four and a half years, and it would be unwarranted to suppose that they will continue to be as favourable in the future. It should be emphasized that the falling interest rates of recent years have not simply assisted borrowing by reducing costs; the more important influence has been that markets were receptive to borrowings in large volume at long maturities.

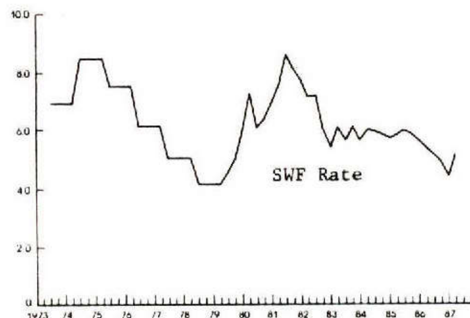
Chart 2

IBRD Average New Borrowing Costs
(Interest Rates in Percent, as of End of Quarter)









20. It is, however, in the third area -- namely, the risk of temporary erosion of investor confidence -- that circumstances have altered most significantly. The Bank is still regarded as a premier credit both by investors and rating agencies. But investors and the rating agencies have become more concerned in recent years about the quality of the Bank's assets and the adequacy of its capital. For example, Standard & Poor's have stated that "The World Bank faces greater financial pressures than other multilateral development banks under a worst-case scenario of appreciable payment delays" (Standard & Poor's Creditweek, September 21, 1987). The Bank has now placed a number of countries in non-accrual status and the potential impact on FY88 net income is a reduction of about $345 million. An early and sizeable General Capital Increase will be very helpful in alleviating any capital adequacy concerns, but it will not by itself dispose of the Bank's vulnerability to protracted loan arrears.

21. The relevance of liquidity policy in this connection is two-fold. First, a high level of liquidity is itself an important part of the overall package of financial strengths which the Bank offers to investors. Second, liquidity may be used to buy time to clarify the extent and severity of any loan servicing problem that may arise, or to explain to investors (and rating agencies) the Bank's capacity to cope with the difficulty.

22. Response Capacity. The second parameter influencing the prudent minimum level of liquidity is the Bank's capacity and willingness to reduce its net cash requirements by cutting back on new loan commitments (and hence disbursements, after a time lag). The increased prominence of fast-disbursing adjustment-support lending in recent years does mean that the Bank has a somewhat greater capacity to conserve on cash requirements through a curtailment of this type of lending. But it would run completely counter to the Bank's intended role for it to rely on this type of response. Moreover, an abrupt cessation of Bank financial support -- for reasons unrelated to the implementation of the borrowing country's adjustment program -- would certainly heighten the risk of additional loan servicing problems and could therefore prove to be counter-productive. Accordingly, the prospect of saving on cash requirements via a cutback in commitments -- which has always been seen as a last resort -- now seems even less feasible than it did at the time of the last review.

23. Critical Threshold. The third element affecting the Bank's need for liquidity is the critical threshold; that is, the point at which a reduction in liquidity becomes a source of investor concern in its own right, leading to a vicious cycle of ever greater reductions in liquid assets and loss of investor confidence. It is clearly impossible to determine this critical threshold with any degree of precision. In the last review, it was assumed that a 50% reduction in the absolute level of liquid assets would be tolerable, provided that markets were convinced that the causes for the decline had been satisfactorily remedied. In today's environment, where a 50% reduction in liquidity would imply a much larger absolute decline -- implying a reduction to below $10 billion -- a higher safety margin would be very desirable. Nevertheless, in the simulations which have been done for this review, the 50% critical threshold has been retained as a rough guide to what might constitute a minimum tolerable level of liquidity in the event borrowings are temporarily interrupted.

Simulations of Borrowing Shortfalls

24. As an aid to judgement, we have simulated various hypothetical shortfalls in Bank borrowings, using different starting levels of liquidity. Table 4 below summarizes the results for the scenarios which seem most relevant to the policy choice facing the Bank. In each of the cases, it is assumed that the Bank's ability to borrow is impaired beginning in the next fiscal year, FY89. In the more moderate "limited shortfall" case, the borrowing shortfall in the first year is 40% of the planned borrowings in that year, declining to 25% in the second year, with a full recovery thereafter. In the "prolonged shortfall" case, the initial reduction is the same, but the recovery is more gradual, spanning five years in all.

Table 4: Simulations of Borrowing Shortfalls
($ million)

Case A: Initial Liquidity at 40% of Three-year NCR - $15734 million

	FY89	FY90	FY91	FY92	FY93
Limited Shortfall					
Planned borrowing program	11259	11600	11652	12750	12269
Indicative borrowing shortfall	4504	2900	0	0	0
Resultant borrowing program	6755	8700	11652	12750	12269
Level of liquid assets	10686	6809	7869	9532	11074
% of three-year NCR	28.6%	18.8%	21.6%	25.8%	28.3%
Prolonged Shortfall					
Planned borrowing program	11259	11600	11652	12750	12269
Indicative borrowing shortfall	4504	3480	2330	1275	0
Resultant borrowing program	6755	8120	9322	11475	12269
Level of liquidity assets	10686	6254	4999	5424	7066
% of three-year NCR	28.6%	17.3%	13.8%	14.8%	18.2%

Case B: Initial Liquidity at 45% of Three-year NCR - $17700 million

	FY89	FY90	FY91	FY92	FY93
Limited Shortfall					
Planned borrowing program	11259	11600	11652	12750	12269
Indicative borrowing shortfall	4504	2900	0	0	0
Resultant borrowing program	6755	8700	11652	12750	12269
Level of liquid assets	12680	8694	9700	11378	12828
% of three-year NCR	33.9%	24.0%	26.5%	30.6%	32.4%
Prolonged Shortfall					
Planned borrowing program	11259	11600	11652	12750	12269
Indicative borrowing shortfall	4504	3480	2330	1275	0
Resultant borrowing program	6755	8120	9322	11475	12269
Level of liquid assets	12680	8139	6830	7270	8824
% of three-year NCR	33.9%	22.5%	18.8%	19.7%	22.5%

Case C: Prolonged Shortfall and Cutback in Commitments

	FY89	FY90	FY91	FY92	FY93
Initial Liquidity 40%					
Planned borrowing program	11259	11600	11652	12750	12269
Indicative borrowing shortfall	4504	3480	2330	1275	0
Resultant borrowing program	6755	8120	9322	11475	12269
Reduction in commitments	1000	1000	1000	1000	0
Level of liquid assets	10849	6759	5942	6921	9045
% of three-year NCR	30.2%	19.5%	17.1%	19.5%	23.9%
Initial Liquidity 45%					
Planned borrowing program	11259	11600	11652	12750	12269
Indicative borrowing program	4504	3480	2330	1275	0
Resultant borrowing program	6755	8120	9322	11475	12269
Reduction in commitments	1000	1000	1000	1000	0
Level of liquid assets	12842	8646	7778	8772	10807
% of three-year NCR	35.6%	24.9%	22.2%	24.6%	28.2%

Note: All cases are based on the FY88 budget projections (base case), which included the following:

($ Billion)	FY88	FY89	FY90	FY91	FY92	FY93
Lending Commitments	15.5	17.0	19.0	20.5	21.1	21.7
Disbursements	11.0	12.2	13.4	14.3	14.8	15.6
Borrowing Program	11.0	11.3	11.6	11.7	12.8	12.3

25. Case A traces through the consequences of these two scenarios on the assumption that the Bank begins with liquidity equivalent to 40% of the three-year NCR. In the "limited shortfall" scenario year-end liquid assets bottom out at just under $7 billion or 18.8%. This must be considered dangerously inadequate. In the "prolonged shortfall" scenario the decline is of course even greater, reaching a low of $5 billion (or 13.8% of the three-year NCR) at the end of FY91.

26. Case B shows what happens if the same shortfalls occur with a different starting point, corresponding to liquidity equivalent to 45% of the three-year NCR. In the "limited shortfall" scenario the bottom reached is just under $9 billion (24%), while the "prolonged shortfall" yields a low of about $7 billion (18.8%). Given the evident arbitrariness of the assumptions made in constructing these scenarios, one should not assign much weight to the particular numerical results that emerge. What matters are the differences attributable to the variations in the initial level of liquidity.

27. Under assumptions corresponding to the "limited shortfall" scenario, the difference could well be crucial in avoiding the so-called critical threshold. In the "prolonged shortfall" case, there is little doubt that 40% would prove inadequate as a buffer, whereas 45% might just enable the Bank to squeeze through.

28. A final case (Case C) shows, for the "prolonged shortfall" case, the effect of cutting back commitments by $1 billion in each year in which borrowings fall short of original plans. It is interesting to note that such cutbacks -- even assuming they can be reconciled with the Bank's role as a lender -- would only raise the low point reached by about $1 billion in FY91, not enough to make the 40% starting point seem viable.

Policy Conclusions

29. Management's judgement is that, because of the increased risk that temporary interruptions in the Bank's borrowing plans may occur at some point in the next few years, it would be wise to increase the minimum planning objective from 40% to 45%. It is not considered likely that such shortfalls, if they occur at all, will be as severe or as protracted as portrayed in the scenarios above. But the path of prudence in Bank finances is to err on the side of caution, and to be prepared to withstand adverse events which are at the limit of plausibility. A shift from 40% to 45% would help keep the Bank in that position, particularly in view of the major uncertainties which exist regarding the extent of liquidity declines which can be absorbed without triggering a cumulative loss of confidence.

Section IV - Discretionary Liquidity

30. The adoption of a prudential minimum level of liquidity leaves open the question of what circumstances would justify allowing liquidity to rise above the minimum, the amount above the minimum being termed "discretionary liquidity". What is at issue here is not the borrowing of unwanted surplus funds, but rather the phasing of contractual funding obligations. Since contractual funding obligations must be met at some time, discretionary liquidity represents merely an earlier phasing of that funding and hence a reduction in the funding risk.

31. The question of what circumstances justify the holding of discretionary liquidity thus becomes the question of what circumstances justify the drawing forward of borrowings. Past reviews of liquidity policy have cited various benefits which may favour such a drawing forward:

- Phasing of the borrowing program. An important part of the Bank's overall funding strategy has been to maintain a relatively smooth progression in annual levels of borrowing. This has sometimes led the Bank to cut the borrowing program by a smaller amount than would be required by a rigid adherence to the minimum planning objective.

- Taking advantage of unusual opportunities. When nominal interest rates have been at or near historic lows, or when it has been possible for the Bank to borrow at unusually long maturities, the Bank has sometimes proposed that borrowings be advanced from one year to another, thereby increasing year-end liquid holdings.

32. Much of the past discussion of the cost and benefits of added liquidity has focussed on the so-called "cost of carry". The basic concept is simple: if $1 billion is borrowed one year earlier than required by the liquidity formula, the Bank incurs the cost of those borrowings (as interest expense) and earns the return on an additional $1 billion of liquid assets. The difference between the two is the "cost of carry". Since the Bank typically borrows at medium or long-term maturities and invests short-term, and since yield curves are typically (though by no means always) upward-sloping, it is natural to expect this cost to be positive. In practice, however, the investment return earned by the Bank is not the static short-term interest rate assumed in the standard comparison. Realized returns are extremely volatile from year to year, so that one cannot meaningfully compute an average.

33. More importantly, the cost (or gain) of carry is likely to be swamped by the difference between the cost of borrowing at the normal time and the cost of borrowing in advance. If, by borrowing in advance, the Bank saves even a few basis points on, say, a 10-year issue, then it will almost certainly have been a wise financial decision to advance the borrowings. Conversely, if the cost of a 10-year issue declines over the

course of the year, then it will have been a poor financial decision even if the Bank manages to avoid any cost of carry during the year. Thus -- as is perhaps intuitively obvious -- the paramount consideration in determining whether it is advantageous to draw forward Bank borrowings is whether it is cheaper to borrow now or later.

34. Unfortunately, neither the Bank nor any other market participant can predict the future course of interest rates -- particularly over a period of a year or longer -- with any degree of confidence. Accordingly, the Bank tends to rely on various indirect indicators of favourable borrowing opportunities, such as:

- nominal or real interest rates are at low absolute levels, judged in relation to actual experience over the past decade or more;

- markets are receptive to issues of unusually large size and/or unusually long maturities;

- the spreads at which the Bank can borrow (measured against traditional benchmarks) are unusually low.

None of these indices is ideal, but each has some value.

35. The fact that nominal interest rates are at or near historic lows does not necessarily mean that further declines are improbable, but it usually does mean that the magnitude of plausible further rate reductions is less than the magnitude of potential rate increases. Moreover, the majority of Bank loans outstanding still carry fixed interest rates (projected to average 8.74% in FY88) which can profitably be financed (or refinanced as earlier borrowings mature) when nominal borrowing costs are low. Comparisons such as these are only valid when applied to borrowings undertaken in a diversified set of currencies, however, since otherwise the low nominal interest rate may simply be compensating for expected exchange rate increases.

36. Apart from the direct impact that re-phased borrowings may have on the Bank's interest expenses and investment returns, there are also certain indirect effects to be taken into account. As already noted, the levels of liquid assets is itself an important part of the financial strengths which the Bank offers to investors. From the point of view of the investors, the higher this is, the better -- for example, in relation to debt maturing in the next five years. Greater investor confidence may in turn be reflected in somewhat narrower spreads on Bank borrowings.

37. Moreover, any drawing forward of borrowings will reduce the Bank's funding risk, both in terms of volume and interest rate. The reduction in volume risk is clear: the greater the level of liquidity, the less the Bank will have to rely on future borrowings to meet its contractual obligations. The impact on interest rate risk is likely to be rather modest, since the amount of borrowings advanced will typically be a small fraction of the total borrowing scheduled for a given year and an

even smaller fraction of the total liabilities that are re-priced in a given year. The latter includes variable rate borrowings as well as new issues. (Further information on the maturity structure of the Bank's assets and liabilities is presented in Attachment III.)

38. Criteria for Discretionary Liquidity. In future reviews of borrowing plans (and the associated projections of liquidity) it is proposed that the above framework be used to assess the desirability of liquid holdings over and above the prudential minimum of 45%. In particular, the case for discretionary liquidity would address the following points:

- direct financial consequences of re-phasing. Primary weight will be given to the outlook for borrowing costs in the currencies in which advance borrowing is to be done. The stronger the outlook for rising rates, the stronger will be the case for discretionary liquidity.

- indirect financial consequences. The implications of re-phasing for the level of liquid assets will be evaluated, giving special attention to investor perceptions and to any special circumstances which may make it desirable to increase the Bank's short-run ability to withstand interruptions in its borrowings.

- considerations of funding strategy. The consequences of re-phasing for the progression of annual borrowings will be described. Priority will be given to avoiding significant departures -- say, greater than ± 10% or 15% -- in the trend of annual borrowings.

This more structured approach will, it is hoped, ensure that planned departures from the prudential minimum only take place on the basis of adequate consideration of all the relevant costs and benefits.

39. Flexible Application. The reference to planned departures from the prudential minimum is not intended to cover situations in which the liquidity ratio goes up because of errors in the Bank's financial projections. The Bank cannot easily, in the short run, project the exact level of liquidity, at a time of volatile foreign exchange rates and a proportional shift in the types of loan being disbursed. Experience of the past five years shows that the outcome for liquidity in a particular year can easily fall in a range of plus or minus 10% of the value expected at the start of the year. Furthermore, the indicator of liquidity, the three-year NCR, cannot be forecast precisely. As part of the current policy review, consideration was given to the sources of volatility in the three-year NCR and to the possibility of substituting an alternative measure of future borrowing requirements. This work is summarized in Attachment IV.

40. The principal conclusion of this review was that the volatility of NCR measure is simply a reflection of the uncertainties affecting the Bank's on-going operations. While more stable measures can certainly be devised, all the ones considered achieve greater stability at the cost of suppressing significant information about the Bank's projected cash flow. Management believes it is preferable, from the point of view of policy, to retain the indicator that best captures the staff's current estimates of the actual borrowing needs of the Bank. Smoothing should occur not by modifying the indicator, but rather by accepting a modest degree of volatility in the liquidity ratio.

41. If the volatility results in a year-end ratio below the 45% level called for under the proposed liquidity policy, then the next year's borrowing program will be adjusted so as to at least restore that level. Indeed, the evolution of the three-year NCR will be monitored within each year. If it appears that revisions in projections will lead to a significant reduction in the liquidity ratio below plans, then adjustments in the borrowing program may be proposed at mid-year.

42. If, on the other hand, volatility results in a year-end ratio above 45%, that too would be corrected in the following year, unless an explicit case were made for discretionary liquidity within the framework discussed above.

Recommendation

43. It is recommended that:

- prudential minimum - for planning purposes the Bank's annual borrowing programs should be formulated so as to achieve year-end liquid holdings of at least 45% of the three-year NCR;

- discretionary liquidity - lasting departures from this level of liquidity would be reviewed and approved by the Board in the context of the annual borrowing program (and, exceptionally, at mid-year) on the basis of the criteria set forth in para. 38 above;

- flexible application - the three-year NCR would be retained as the indicator of liquidity requirements, recognizing that this may lead to unforeseen fluctuations in the year-end level of the liquidity ratio.

FRS
December 9, 1987

Attachment I

THE HISTORY OF IBRD LIQUIDITY: FY47-FY88

		Cash and Investments End FY	Ratio of Cash and Investments to		
			Undisbursed Loan Balance End FY	Disbursements Following FY	Next 3 Yrs' Net Cash Requirements a/
			Phase I Indicator	Phase II Indicator	Phase III Indicator
		---($M)----			----(%)-----
Phase I	FY47	156	4.00		
	FY48	421	9.79		
	FY49	453	3.65		
	FY50	457	2.47		
	FY51	469	1.17		
	FY52	530	1.05		
Phase II	FY53	443	0.97	1.47	
	FY54	456	0.99	1.66	
	FY55	528	0.91	1.86	
	FY56	454	0.64	1.36	
	FY57	553	0.77	1.11	
	FY58	987	1.10	1.69	
	FY59	1062	1.03	1.95	
	FY60	1222	1.10	3.07	
	FY61	1594	1.21	3.29	
	FY62	1804	1.06	2.91	
	FY63	1743	1.14	3.12	
	FY64	1589	0.92	2.62	
	FY65	1613	0.75	2.41	
	FY66	1417	0.61	1.79	
	FY67	1539	0.65	1.99	
	FY68	1401	0.59	1.84	
	FY69	1848	0.61	2.39	
Phase III	FY70	2092	0.54	2.19	66
	FY71	2566	0.54	2.13	63
	FY72	3229	0.59	2.67	63
	FY73	3777	0.60	2.35	57
	FY74	3824	0.48	1.82	48
	FY75	5230	0.52	2.06	60
	FY76	6316	0.50	2.32	65
	FY77	7885	0.51	3.00	67
	FY78	8857	0.48	2.55	54
	FY79	9750	0.45	2.23	54
	FY80	9966	0.40	1.93	46
	FY81	8371	0.30	1.31	35
	FY82	9394	0.29	1.37	36
	FY83	13196	0.37	1.52	43
	FY84	14869	0.39	1.68	41
	FY85	17360	0.43	2.08	45
	FY86	20014	0.46	1.76	50
	FY87	18802	0.42	1.68 *	48
	FY88	18393 *	0.37 *	1.46 *	47 *

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a/ The three years' net cash requirements projected in the corresponding fiscal year.

* Denotes values that are based on projections in the FY88 Budget.

Comparison of Liquidity Policies of Multilateral Development Banks

1. The multilateral development banks (MDBs)[1/] fund themselves primarily in the capital markets. Since there is a lag between the time of commitment and disbursement of loans, these institutions do not fully prefund their contractual obligations, and so liquidity policy plays an important role in their overall financial management.

2. As is the case with IBRD, the liquidity policies of AsDB, IADB and AfDB are conservative. The following table compares these liquidity policy guidelines.

	Liquidity Policy Guideline
IBRD	To be maintained at 40-45% of net cash requirements over the next three years.
IADB	At least equal to 50% of undisbursed loans or projected loan disbursements over the next two years whichever is higher.
AsDB	Must be no less than 40% of undisbursed loans.
AfDB	Must be no less than 200% of next year's projected loan disbursements and debt service.

In general the MDBs try to keep their liquidity level at or above their liquidity policy guideline. At the end of FY87, IBRD liquidity stood at 42% of undisbursed loans, 97% of the next two years' estimated loan disbursements, and 79% of the next year's estimated loan disbursements and debt retirement. Thus, IBRD's liquidity practice was on the whole less conservative than the minimum policy guidelines of other MDB's.

3. The following two tables compare MDBs' liquid assets as a percentage of both total debt outstanding and undisbursed loans plus one-year debt service.

1/ Besides IBRD, the three other MDBs included in this analysis are Asian Development Bank (AsDB), Inter-American Development Bank (IADB) and African Development Bank (AfDB).

Liquid Assets/Debt [2/]
(%)

	IBRD	IADB	AsDB	AfDB
FY82-83	33.3	50.6	67.2	44.5
FY83-84	34.8	49.6	63.8	51.0
FY84-85	39.5	44.1	70.4	81.3
FY85-86	30.1	42.0	64.5	74.6
FY86-87	24.0	37.5	59.9	64.1

Liquid Assets/(Undisbursed Loans+One Year Debt Service) [3/]
(%)

	IBRD	IADB	AsDB	AfDB
FY82-83	38.5	34.3	49.5	15.6
FY83-84	43.3	33.0	53.5	18.7
FY84-85	53.6	30.0	59.1	45.8
FY85-86	50.2	38.9	70.9	40.8
FY86-87	40.4	40.9	78.4	37.7

As can be seen from the above tables IADB, AsDB and AfDB manage their liquidity somewhat more conservatively in relation to total debt outstanding. The picture is more mixed for liquidity in relation to undisbursed loans; AsDB has the most conservative liquidity policy on that basis, whilst IBRD's position has not varied much as a percentage of undisbursed loans but has grown less conservative relative to the other MDB's in recent years.

4. In conclusion, liquidity policy is one of the important financial management instruments for MDBs. The liquidity policy guidelines for MDBs remain conservative. On a comparative basis, based on ratios shown above, the liquidity policies of IADB, AsDB and AfDB remain somewhat more conservative than IBRD's. Moreover, the volatility of these ratios from year to year suggests that the management of liquidity level is rather complex and not simply a matter of applying a percentage formula mechanistically.

2/ Source: S&P Credit Review, September 21, 1987. Note that IBRD fiscal years are from July 1 to June 30, whereas, fiscal years of other MDBs coincide with calendar years.

3/ Source: S&P Credit Review, September 21, 1987. For IBRD and AsDB, the debt service figures include interest and scheduled principal payments; for the other banks, debt service figures include interest and all principal payments.

FRS
11/13/87

Attachment III

The Maturity Profile of the Bank's Assets and Debt

1. The relative maturities of the Bank's assets, comprising loans and liquidity, and debt are significant to liquidity policy in terms of exposure to interest rate and funding risks. The table below shows the maturity structure, by fiscal year, for the Bank's outstanding approved loans and outstanding debt as at June 30, 1987. This table simply shows the static picture of the IBRD's loan and debt maturity schedules at that time. It therefore illustrates the degree of funding risk associated with undisbursed loan commitments; it also gives some indication of interest rate exposure, but in both cases this table is only indicative of the positioning that was already in place on June 30: it does not include the effects of projected new lending.

2. The funding risk comes from two sources. One is the extent to which debt is of shorter maturity than loans, leading to a need to re-finance the loans, which increases the net cash requirements of the Bank. The Bank' loans are typically of initial average life roughly 11 years (and final maturity around 17 years); whereas the average life of new borrowings, although varying considerably from year to year, is shown in this table to be less than 11 years. Funding risk also arises to the degree that commitments have not been prefunded [1].

3. The funding risks are offset partially by the holdings of liquidity, because liquidity represents advance borrowing as has been emphasized in the main body of this paper. The average life of the investment portfolio itself varies considerably from month to month (indeed from week to week), since it is actively managed, and often would be rather short, e.g., one year or less, although in principle it could range up to about five years (the exact range is specified in terms of duration, which is a type of time-weighted average life).

4. A related effect of the maturity mismatch is the exposure to interest rate risk. Inasmuch as debt is shorter than loans, the need to re-finance introduces the risk that the rate of interest on new borrowings could be higher than the earning yield on the loans. In the case of fixed rate loans, the Bank bears the risk, whilst for variable rate loans, the risk is passed on to the borrowers. Consequently, the interest rate exposure of the Bank is, in theory, reduced by the liquid holdings, because the average life of assets is reduced. In practice, the sensitivity to interest rates is more complicated because the investment portfolio is actively traded. When interest rates rise, the holding return on very short-term investments (e.g. money market deposits) also rises; but to the extent that the investment portfolio is extended in maturity, capital losses are incurred, which may or may not be realised. Therefore, the effect on net income is more complex than the average life of Bank assets alone might suggest.

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[1] This difference, however, also shows a shortcoming of analysis based on a maturity profile at a particular instant: the profile does not, indeed cannot, account for the maturities of new borrowings in the future. These maturities depend upon market circumstances and availabilities, and can vary considerably year by year. For example, in recent years, the average maturity of new medium- and long-term IBRD borrowings has varied from a low of 5.8 years in FY84 to a high of 13.7 years in FY86.

Maturity Profile of Loans Approved and Borrowings Outstanding
($ Million, by fiscal year)
As at June 30, 1987

Fiscal Year	Loans	% of Total	Medium- and Long Term** Borrowings	% of Total
FY88	6,870	5.7	9,573	12.4
FY89	7,824	6.5	9,413	12.2
FY90	8,715	7.2	7,921	10.2
FY91	9,422	7.8	6,326	8.2
FY92	9,734	8.1	7,490	9.7
FY93	9,897	8.2	6,478	8.4
FY94	9,701	8.1	5,088	6.6
FY95	9,061	7.5	5,320	6.9
FY96	8,369	6.9	5,217	6.7
FY97	7,615	6.3	4,387	5.7
FY98	6,964	5.8	608	0.8
FY99	6,071	5.0	467	0.6
FY2000	5,098	4.2	792	1.0
Thereafter*	15,147	12.6	8,221	10.6
TOTAL	120,488	100.0	77,301	100.0

Short-term borrowings outstanding:
(of initial maturity one year or less) $4,498 million

Investment Portfolio:	Book Value	$18,774 million
	Average duration	1.00 years

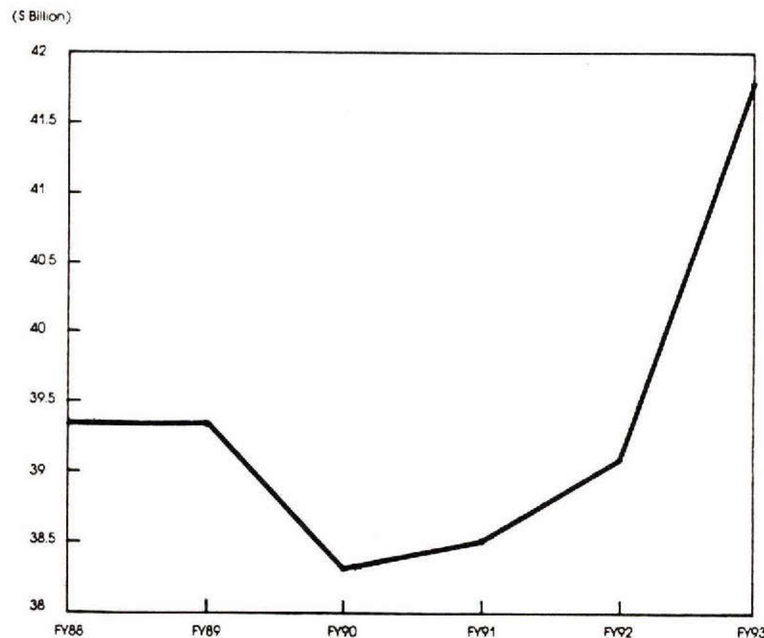
* Includes amounts not allocated to specific maturities.
** All figures including the total are quoted after swaps.

The Indicator of the Level of Liquidity

1. The Bank has used the next three years' net cash requirements (the three-year NCR) as its indicator of the desired minimum level of liquidity since 1971. The concept underlying the three-year NCR is in essence simple: that the Bank needs to make some advance provision for the balance (outgoing over incoming) of foreseeable cash flows, whose funding will require new borrowings. The cash flows are projected over three years because that is taken to be a reasonable time to allow for recovery from some event which might result in a borrowings shortfall. The balance of outflows and inflows includes not only contractual commitments but also flows consequent on projected future actions, such as projected disbursements relating to future commitments.

The chart shows the projected value of the three-year NCR for the next few years. The dip around FY90 and FY91 occurs mainly because of high loan repayments and low debt retirement in those years.

Projected Three-Year NCR



2. While the NCR is conceptually the most appropriate indicator on which to base the Bank's liquidity requirements, it has proven to be rather difficult to forecast. Attempting to project the NCR over three years has only multiplied the difficulties. Table 1 shows the margins of error entailed in forecasting the main elements of cash flow (other than borrowings): disbursements, net income, debt retirement, and loan repayments. The table shows for the past ten fiscal years the actual outturn, the projection at the start of the fiscal year, and the difference between the two, for these elements. Also shown is the ratio of the standard deviation of the projection errors to the average of the corresponding actuals. This ratio is of interest because it is effectively a measure of unpredictability that can be directly compared for different time periods.

Table 1: Projection Errors in Major Elements of Cash Flow
($ Million)

	FY78	FY79	FY80	FY81	FY82	FY83	FY84	FY85	FY86	FY87	FY78-FY82 Average	FY83-FY87 Average	FY78-FY87 Average
ACTUAL													
Gross Disbursements	2625	3478	4363	5171	6374	6852	8673	8869	8347	11403	4402	8829	6616
Net Income	238	407	588	610	598	752	600	1137	1243	1113	488	969	729
Debt Retirement	1465	1850	2791	2722	2829	2943	2657	3948	4850	7837	2331	4447	3389
Loan Repayments	1050	1019	1206	1466	1709	2058	2546	2975	4121	6087	1290	3557	2424
PROJECTIONS													
Gross Disbursements	3558	3400	4300	5200	6100	7462	8560	10200	9590	9250			
Net Income	243	286	471	554	614	582	550	750	800	950			
Debt Retirement	1404	1762	2571	2633	2916	3001	2481	4478	4167	7015			
Loan Repayments	805	924	1028	1321	1793	2236	2725	3400	3413	5060			

PROJECTION ERRORS	FY78	FY79	FY80	FY81	FY82	FY83	FY84	FY85	FY86	FY87	FY78-FY82 STD DEV	FY78-FY82 Ratio (%)	FY83-FY87 STD DEV	FY83-FY87 Ratio (%)	FY78-FY87 STD DEV	FY78-FY87 Ratio (%)
Gross Disbursements	933	-78	-63	29	-274	610	-113	1331	1243	-2153	473	10.7	1429	16.2	1004	15.2
Net Income	5	-121	-117	-56	16	-170	-50	-387	-443	-163	65	13.3	166	17.1	155	21.3
Debt Retirement	-61	-88	-220	-89	87	58	-176	530	-683	-822	109	4.7	552	12.4	383	11.3
Loan Repayments	-245	-95	-178	-145	84	178	179	425	-708	-1027	124	9.6	636	17.9	434	17.9

Note (1) The projections are those made at the start of the fiscal year.
(2) Debt retirement represents medium-and long-term debt retirement.
Loan repayments represent repayments and sales of loans.
(3) "STD.DEV." denotes the standard deviation, and the ratio shown is that of the standard deviation of the projection errors to the average of the corresponding actuals, expressed as a percentage.

In terms of absolute dollar amounts, by far the largest cause of projection errors is disbursements; by contrast, projections of debt retirement and loan repayments, although individually sensitive to foreign exchange rate fluctuations, taken together are a much less serious forecasting problem as far as net cash flows are concerned. There are also minor components of the three-year NCR that cause forecasting errors, such as the volume of short-term debt retirement, the increase in usable capital, and the amount of loan cancellations, but none of them is of great significance individually. We can sum up these various factors by saying that in practical terms the expected range of error associated with a forecast of the three-year NCR is about plus or minus 8%. The details justifying this number are given in Table 2 on the predictability of the three-year NCR. The principal culprit is the projection of disbursements.

Table 2: The Predictability of the Next Three Years
Net Cash Requirements
($ million)

	FY78	FY79	FY80	FY81	FY82	FY83	FY84	FY85	FY86	FY87
Projected 3-yr NCR	16457	17978	21448	23776	26218	30390	36455	38897	39814	39139
Actual 3-yr NCR	15350	18373	20262	22265	23814	26892	31396	34602*	38640*	39442*
Projection Errors	1107	-395	1186	1511	2404	3498	5059			

Average actual three-year NCR: $22622 million (FY78-FY84)
Standard deviation of projection errors: $ 1788 million (FY78-FY84)
Ratio: 7.9%

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* Denotes values that are based on projections in the FY88 Budget.

Note: Projected three-year NCR's are those projected at the beginning of the corresponding fiscal year.

3. Table 3 shows, for the past ten fiscal years, the rate of disbursement expressed as a percentage of the undisbursed loan balance, categorized by type of lending: adjustment lending or other. In each case, the undisbursed loan balance shown is that amount at the start of the corresponding fiscal year and excludes loans approved but not yet effective. The rates have been calculated for their respective balances.

Table 3. Components of Rates of Disbursement

(US$ million)	FY78	FY79	FY80	FY81	FY82	FY83	FY84	FY85	FY86	FY87
Adjustment Loan Disbursements	32	95	235	463	906	871	1839	1424	1348	3232
Und. Adjustment Loan Balance*	3	122	297	344	220	322	482	1283	872	1502
Ratio (%)	938	78	79	135	413	271	382	111	155	215
Other Loan Disbursements	2593	3383	4128	4708	5468	5981	6834	7445	6999	8171
Undisbursed Other Loan Balance*	11276	13640	16008	17767	21361	24667	27629	28783	28405	30964
Ratio (%)	23.0	24.8	25.8	26.5	25.6	24.2	24.7	25.9	24.6	26.4
Cancellations	247	55	260	459	390	414	758	1188	1354	1763
Total Undisbursed Loan Balance*	11280	13761	16304	18111	21581	24988	28111	30067	29277	32466
Ratio (%)	2.2	0.4	1.6	2.5	1.8	1.7	2.7	4.0	4.6	5.4

		Average	Standard Deviation
		--------(%)--------	
Disbursements/Undisbursed Balance:	Adjustment Loans	264	240
Disbursements/Undisbursed Balance:	Other loans	25.20	1.10
Cancellations/Undisbursed Balance:	All loans	2.61	1.53

* At start of FY, excluding loans approved but not yet effective.

It is evident that the absolute amounts of disbursements on adjustment lending (comprising SAL's and SECAL's) are extremely volatile from year to year and bear no stable relationship to the undisbursed adjustment loan balance. The disbursements on non-adjustment lending, on the other hand, form a fairly stable ratio to the undisbursed balance. Thus the figures support the commonsense expectation that the increased proportion of fast-disbursing adjustment lending is the root cause of the difficulty in forecasting disbursements -- a difficulty which is not mitigated by the three-year time horizon.

4. The difficulties experienced in forecasting the three-year NCR raise the question whether the Bank could adopt a better indicator of liquidity needs such as one of the Bank's earlier liquidity indicators, the undisbursed loan balance and the one-year gross disbursements, or some combination of them. There are three reasons to reject this line of thinking. First, the older indicators were certainly suited to the historical circumstances of the Bank at the time they were used, but those times have changed. For example, in the earliest years of the Bank's operation, when its credit standing was yet to be established, it made sense to fund all commitments fully, whether disbursed or undisbursed; today there is not that need. Second, and more positively, the concept of net cash requirements exactly captures the funding needs of the Bank over the near term, in the framework of the Bank's established mode of operations: for example, the regular re-financing of maturing debt, the strong flow of loan repayments, and the record of steady profitability. In other words, if we could perfectly project net cash requirements, we would have an ideal indicator of liquidity needs; the problem lies not in the concept, but in the practicalities of forecasting it. Third, the difficulties of forecasting are not confined simply to the three-year NCR as a whole, but arise also in each component of the Bank's cash flow, most notably in disbursements. Consequently, it is hard to imagine any useful indicator of liquidity needs that would escape the problems of forecasting. For example, although the undisbursed loan balance grows more steadily year by year than does net cash requirements, statistical investigations show that it is not more easily forecast. We conclude that the difficulties of forecasting are not unique to the three-year net cash requirements, but characteristic of any useful indicator that reflects disbursement projections.

5. If it is accepted that the three-year NCR is a measure of imminent funding risk, but that in all probability forecasts of disbursements will remain imprecise, we re-inforce the conclusion of Section IV of this paper that the planned percentage level for liquidity ought to be applied with a degree of flexibility. In other words, if we hold relatively little confidence in our forecast -- even our best forecast -- it makes no sense to subject the level of liquidity and the size of the borrowing program to excessive fluctuations on the basis of that forecast.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 18, 1987

TO: Policy Committee Members

FROM: Barber B. Conable

EXTENSION: 72001

SUBJECT: Information Management and Technology, Policy Committee (IMT-PC) Terms of Reference

I have reviewed with Mr. Wapenhans the attached Terms of Reference for the Information Management and Technology, Policy Committee (IMT-PC). While I realize that full agreement has not yet been reached, it is time to proceed with these Terms of Reference. I am prepared to review the performance of the proposed IMT-PC after one year of operation in order to determine whether further improvements are necessary.

Attachment

Barber Conable

TERMS OF REFERENCE

FOR

INFORMATION MANAGEMENT AND TECHNOLOGY POLICY COMMITTEE (IMT-PC)

Membership

1. The membership of the IMT-PC will be as follows:

Chair:	SVP External Affairs and Administration
Members:	One senior line manager each from Finance, Operations, PPR, IFC, Director PBD and a senior representative of the General Counsel.

The aim of this participation in the IMT-PC is to ensure proper consultation and coordination on activities in the information management and technology field that affect the Bank and the major complexes including IFC such as sharing of data, interconnection of hardware and software as appropriate, via electronic networking.

Representatives will be nominated by members of the Policy Committee. Normal terms of appointment will be 2-3 years. Each nominee will be a senior line manager and normally also will chair a high-level Information Management and Technology Committee within his/her own Complex/IFC or be closely affiliated with such complex-wide work.

Secretariat

2. The Director, Information, Technology and Facilities Department will be the Secretary of IMT-PC. He will be responsible for the agenda, documentation and staff attendance, as necessary. He will ensure that the deliberations and decisions of the Committee take place on the basis of completed staff work. The Secretariat will also be responsible for the recording, safe keeping, communication and follow-up, as necessary, of decisions made, and for such measures as are required to protect the confidentiality of the proceedings.

3. When required, the Committee will have access to advice, as necessary, from Bank and outside experts with specialized first-hand knowledge of relevant information technologies.

Responsibilities

4. The IMT-PC is charged with the responsibility to establish and monitor the application of institution-wide strategies, guidelines and standards for information management and the technological means required to meet the information management needs. It will commission reviews and decide on strategies, policies, plans and investments for the management of institution-wide information systems and their technology requirements. The Chairman will keep the President informed of major decisions of the IMT-PC.

5. To perform the above role, the specific responsibilities of the Committee will include the following:

(a) maintain an institutional oversight of information management activities and decide on strategies, policies and plans affecting the management of information and information technology in the Bank;

(b) approve and issue institutional guidelines, investment criteria and standards for management of information systems and their requisite technology;

(c) review, amend and endorse plans and investments in information management that have an institution-wide impact;

(d) monitor the overall information management activities in the Bank, review implementation of agreed strategies and plans, and review and coordinate MIS activities;

(e) provide for active surveillance of information technology innovation, and review and develop mechanisms for promotion and application of advanced technology in the Bank's business processes, as required to implement effectively and efficiently the Bank's information management policy (i.e., establishment of an Information Technology Innovation Fund);

(f) review and approve an annual report on information management and associated technological strategy to the Policy Committee.

Decision Making

6. The Committee is expected to operate on a consensus basis. In case of opposing views, the Chairman will give his views which shall be final unless brought to the Policy Committee for discussion and decision by the President. For decisions concerning additional budgetary resources, the Chairman will seek approval from the President, in consultation with the Director, Planning and Budgeting Department.

Bank-wide Committee Structure and Relationships

7. Within the policy and strategic framework established by IMT-PC, each of the four main complexes and IFC is responsible and accountable for formulating and implementing its own information management strategies, plans and activities. The technologies, and especially the hardware needed to implement these activities, will be discussed with the Director, ITF and will be procured in accordance with the Bank's internal procurement procedures. Specifications will be developed with the concurrence and help of ITF. Each Bank complex (Administration, Finance, Operations, and PPR) is expected to maintain an Information Management and Technology Committee to address policy and strategy matters, to ensure consistency with Bank-wide policies and programs, and to oversee management of its information resources in accordance with its business needs. A suitably qualified senior staff member from ITF will be designated as the primary contact point for each Complex-level Committee. This staff member will be invited to represent ITF at local Committee meetings and to participate in those meetings where issues of institution-wide impact are to be considered. The Operations Evaluation, Legal and Secretary's Departments will join the Administration Complex Committee.

8. IMT-PC may, as necessary, establish specialized committees to help resolve priority issues, to facilitate coordination at a Bank-wide level, or to address technology issues.

December 18, 1987

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 4, 1987

TO: Members, Policy Committee

FROM: Barber B. Conable

EXTENSION: 72001

SUBJECT: Information Management and Technology Policy Committee

I understand no agreement has been reached on the Terms of Reference for the Information Management and Technology Policy Committee and that no meeting of the Committee has yet taken place.

Coordinated information management is central to our reorganization effort and must be implemented as soon as possible.

I would appreciate receiving the agreed-upon Terms of Reference by c.o.b. December 15. In case of continuing divergent views, I plan to review and decide the outstanding issues before the Christmas break.

Barber Conable

THE WORLD BANK

Office of the President

October 14, 1987

Mr. Willi Wapenhans

Willi:

Re: IMTPC--Terms of Reference

I would appreciate your working out with the interested parties Terms of Reference acceptable to all concerned, along the lines of the discussions this morning.

I am, in particular, concerned that the Committee remains a true Policy Committee which: (i) establishes and monitors institutional guidelines and strategies for information management and technologies; but (ii) reviews and endorses plans and investments of institution-wide significance only.

Barber B. Conable

cc: Members, Policy Committee

DECEMBER 7 MTG.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 8, 1987

TO: Files

FROM: Marianne Haug, EXC

EXTENSION: 73585

SUBJECT: Minutes of the Policy Committee of December 7, 1987

Members Present
Messrs. Conable, Hopper, Qureshi, Ryrie, Shihata, Wapenhans

Acting Members

Messrs. Burmester, Wood

Other Staff Members

Messrs. Armington, Baneth, Stanton, Wood, Tanaka
Mmes. Handwerger, Haug

United Way Campaign

Mr. Conable opened the meeting by inquiring about the status of the United Way Campaign. Mrs. Handwerger reported that participation to date is under 10% although the average contribution size is high, at US$174. While the campaign is usually slow at the start, Mrs. Handwerger recognized that there was some apathy and a lack of stimulation to contribute. Mr. Conable noted that substantial effort would be necessary to reach last year's contribution rate of 58%. Mrs. Handwerger mentioned that the Campaign would be extended into January to allow broader participation. Mr. Conable urged members of the Committee and managers to insure a successful campaign and to consider the implications of contributions significantly lower than in the past. Mr. Conable considered that any resident of Washington should support the community, and would ultimately benefit from contributions to the United Way. Mr. Conable mentioned also that US staff would have more incentive to contribute before January 1 due to the current higher maximum tax rate. Mrs. Handwerger informed that speakers and a video tape could be provided for presentation to units, and that the United Way could, on request, channel contributions to specific reputable charities located outside the Washington area.

Mr. Conable concluded the discussion by stating that the personal attention of Policy Committee members to increasing participation within their units by the end of the year would allow Campaign results to reach an adequate level.

World Economic Outlook

Mr. Conable requested comments by Mr. Baneth on the world economic outlook for 1988 to 1990 which is being completed. Mr. Baneth mentioned

that no significant revisions of forecasts had been made following the October 19 stock market collapse. Forecasts were already pessimistic and did not therefore require significant adjustments. Mr. Baneth perceived that the October 19 events would have a depressive effect mainly on the US, while policy changes remained inscrutable in terms of collaboration on monetary issues and of economic policy in Europe (particularly Germany) and Japan. Mr. Baneth reminded the Committee that the low growth forecast envisaged in 1985 had occurred. Mr. Baneth further mentioned that no strong recession was currently considered and that a 'muddling through' scenario had been adopted. A recession could however be caused by a further decline of the dollar and a rise in interest rates. Mr. Baneth considered in particular that a recession could also result from an overcompensation of adjustment around 1990. The scenario reflected therefore slow growth in 1989, and even slower growth for 1990. In response to a question from Mr. Conable, Mr. Baneth mentioned that the forecasts depended heavily on political outcomes of current discussions on economic and fiscal matters. In addition, commodity prices which have declined significantly in real terms over the last few years, are expected to drop still further. Mr. Wapenhans noted the potential impact of further commodity prices declines on country creditworthiness and lending levels considering the effect of such declines on borrowing country economies.

Mr. Wapenhans inquired whether the OECD projections assumed no change in the current trade structure. Mr. Baneth commented that no significant change in trade structure was currently envisaged. Mr. Qureshi noted that interest rates were forecasted to decrease. Mr. Baneth answered that while the LIBOR would probably increase in nominal terms, it was expected that US inflation is likely to pick up during the period. Mr. Qureshi also noted that OECD forecasts a continuous decrease in GDP growth rates. Mr. Baneth explained that the Bank forecast assumed that US fiscal adjustment would occur later than in the OECD forecast. Mr. Qureshi commented on the impact of exchange rate adjustment on the improvement of external accounts. Mr. Baneth acknowledged that adjustment of the exchange situation could precede fiscal adjustment, and that such a path would, in the short term, favor the US and be less advantageous to Europe. The other path, which had not been considered, could include increased inflation levels.

Mr. Ryrie considered that the forecasts appeared reasonable, but that the Bank should develop, for its own purposes, more detailed scenarios. Mr. Conable inquired about the status of contingency planning in the Bank. Mr. Baneth considered that insufficient attention was given to reasonable alternative cases and recommended that, while the main scenario should be distributed to the Board, management should develop internal plans to address lower-probability worse scenarios. Mr. Hopper informed that PPR was developing strategies for adversity based on tougher assumptions and worse scenarios. Mr. Conable commented that these were useful exercises and encouraged their pursuit.

Mr. Conable concluded the discussion by mentioning that the forecasts appear reasonable. Mr. Conable commented on the value of contingency planning within the current uncertain environment and said that he would welcome comments on this topic from Committee members.

Report on DAC and Special Program for debt distressed, low income African Countries with adjustment programs

Mr. Conable thanked and congratulated Messrs. Qureshi and Jaycox on the positive outcome of the DAC high-level and Africa Special Program meetings in Paris. Mr. Qureshi considered that the DAC high-level meeting had been very successful. Careful preparation and consultation with donors over the last four months have contributed to this success. Such preparation led donors to understand that programs, in particular for Africa, are severely underfunded, and that while there is an opportunity for adjustment in most African countries, additional funding is necessary if credibility and influence are to be maintained. The DAC Ministerial meeting was very well attended and dealt with three main items: the African issue and donor response; lessons from adjustment lending; and aid coordination. In relation to this last item, there was a strong feeling that the coordination between Bank and donors has been less than satisfactory in the past, and that procedures must be improved to involve donors earlier as full participants in the design and implementation of adjustment programs. The meeting reflected a realization that the time had come for a cohesive approach. Mr. Conable requested that a brief report be made to the Board the following day.

Mr. Sandstrom informed that the multidonor meeting sought to obtain an indication of the amounts of additional financing for the Special Program, provide a brief review of the enhanced SAF and assess the scope of Paris Club reschedulings. The Meeting was well attended by 17 countries and key organizations such as the EEC, OECD, the African Development Bank and the UNDP. Mr. Sandstrom considered that the meeting had been a success in both the amounts of commitments received and tone.

An overall amount of US$6.4 billion was pledged for the 1988-1990 period in support of adjustment financing. This would result in additional disbursements of US$3 billion over the period, corresponding to an additional billion dollars per year. This surpassed expectations initially set around US$300 to 500 millions per year. More than half of the amount pledged would be cofinanced with the Bank, while the complement would be in the form of highly coordinated parallel arrangements. Mr. Sandstrom provided the amount pledged by each major donor, distinguishing the additional portion.

Mr. Sandstrom stressed the good tone of the meetings which reflected, in the opinion of several donors, the beginning of a new partnership with the Bank. This increased partnership included also requests for earlier involvement, more consultation and direct participation in missions. Such partnership would be demanding in terms of staff time and delicate in relation to concerned governments. Donors are also seeking to establish a separate identity and visibility in their support of adjustment operations. Mr. Sandstrom noted also the positive momentum which characterized the meeting as the Bank was perceived to be less formal and more attentive. Several donors stressed the importance of social dimensions of adjustment and of closer collaboration on PFPs.

Mr. Sandstrom noted that several donors were seeing positive results emerging from adjustment programs, the implications of program

underfunding as in the case of Zambia, and the difficulty for a single lender to provide the necessary financing. Such perception contributed to the successful outcome of the meeting. The issue of conditionality was also raised as the UK requested clearer rules, and an automatic link between Bank/IMF conditionality and actions from other donors. Other donors favored a case-by-case approach with no such automaticity.

Mr. Sandstrom concluded his presentation by stating that, during the next step, donors would submit in writing their pledges specifying, among other factors, terms and procurement procedures. Meetings are envisaged on a six-monthly basis, with the next meeting currently scheduled for March 14, 1988 in Washington.

Mr. Shihata questioned the additionality of the funds involved, remarking that a significant portion of these funds came from reallocation of existing ODA flows. While acknowledging the important share of funds reallocated away from project investment and from other country groups, Mr. Sandstrom mentioned that true additional contributions had been made, and that further analysis would be necessary to determine their exact magnitude.

Mr. Wapenhans felt this was an impressive beginning, but was concerned that these amounts may be limited in the context of the losses associated with continuously declining commodity prices. Mr. Qureshi acknowledged that aid amounts remained small when compared to trade losses, and that a depressing growth scenario made adjustment more difficult.

Mr. Conable concluded by noting that the initiative contributed to ease the difficult situation of African countries concerned and by commending staff for the successful outcome of the meetings.

Miscellaneous

Mr. Conable briefed Committee members on the status of his dialogue with the US Treasury on the GCI. Mr. Shihata recommended that the Board be informed about the Romanian situation. In response to a question on Poland by Mr. Hopper, Mr. Qureshi mentioned that the pace of reform would slow down although the precise impact on the timing of individual reform measures was not known yet. Mr. Conable commented that price increases had been phased down.

JT

POLICY COMMITTEE MEETING

Monday, December 7, 1987

10:00 a.m.

AGENDA

* 1. **United Way Campaign**
(Mrs. Gretchen Handwerger)

* 2. **World Economic Outlook**
(Mr. Jean Baneth)

* 3. **DAC Meeting and Multidonor Meeting on Special Program of Assistance to debt distressed, low-income African countries with adjustment programs**
(Messrs. Moeen Qureshi & Edward V.K. Jaycox)

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* No documents

NOVEMBER 25 MTG.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 10, 1987

TO: Members, Policy Committee

FROM: Barber B. Conable

EXTENSION: 72001

SUBJECT: POLAND--Country Strategy Paper

I am circulating with this note the Minutes of our discussion on November 25, 1987, on the Poland Country Strategy Paper.

Following the negative implications of the recent referendum in Poland, I do not wish to decide on a specific level of World Bank lending to Poland in FY88/89 at this time. I intend to review the scope and timing of the reform program as it unfolds over the coming months and discuss the matter again with the Policy Committee at the appropriate time.

Barber B. Conable

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 30, 1987

TO: Files

FROM: Marianne Haug, EXC

EXTENSION: 73585

SUBJECT: Minutes of the Policy Committee of November 25, 1987

Members Present
Messrs. Conable, Qureshi, Ryrie, Shihata, Stern, Wapenhans

Acting Members

Messrs. Choi, Rajagopalan

Other Staff Members
Messrs. Lari, Lav, Pohl, Stanton, Steer, Tanaka, Thalwitz
Mmes. Haug, Loos

Poland Country Strategy Paper

Mr. Conable opened the meeting by noting that Poland seemed to elicit enthusiasm from Bank staff as an opportunity was perceived to implement significant reforms. Mr. Thalwitz stressed that the Region realized that the task of implementing a reform program is a daunting one and recognized the difficulty of such task based on previous experience with injecting market mechanisms within a highly indebted socialist economy. Mr. Thalwitz perceived a window of opportunity, and pointed out that, while there is a recognition of the need for reform by Polish authorities, the political situation is fragile and the need for consensus with the population remains to be achieved. Mr. Lari agreed with Mr. Conable that a compounding issue is that the population may equate reform with higher prices.

Mr. Thalwitz mentioned that some European countries would favor the establishment of a program with Poland while France was currently more reluctant and the US ambivalent. Mr. Conable noted that the arrangement with the Paris Club had been favorably perceived.

Recognizing the considerable political uncertainty associated with any operation in Poland, Mr. Thalwitz stressed that the first operation would be contingent on the IMF reaching agreement with Polish authorities. The start of operations with Poland would be conditional on a letter of development policy and on more concrete sector policies. Mr. Thalwitz stressed that the Bank would not proceed until agreement is reached between Polish authorities and the IMF, and on the steps set out in p.15. Mr. Conable then enquired about the status of the IMF work. Mr. Thalwitz replied that a mission was just returning from Poland. Mr. Lari mentioned that while the mission had not yet a formal mandate to negotiate with Poland, it was very impressed by the courageous steps being considered in terms of price reform, budget policy, the phasing out of the central

allocation system, the reduction of the ministries and the role of the central bank. It was important now to focus on the means to reach the stated goals. An IMF mission would be returning to Poland in February, preferably with the Bank. The IMF would be considering a Stand-By of 50% of quota equivalent to US$340 million. Mr. Lari mentioned that Polish authorities had stated that even in the absence of Fund financing, it would still be interested in a formal IMF presence and technical assistance. Mr. Lari also mentioned that the Polish government would like to complete Stand-By agreements during the first half of calendar 1988, although the second half of calendar 1988 appears as the more probable date. Timing would be determined by the outcome of the February mission.

Mr. Conable emphasized the issue of political sustainability of the reform program, particularly if reform is perceived by the population mostly in terms of price increases. Mr. Conable noted the role of the IMF, and stressed the need for strong commitment. Mr. Conable then addressed the issue of lending level, stating that while he could conceive an initial commitment of up to US$250 million followed by a thorough review of reform progress, he would not like to commit the Bank to a larger longer-term program in Poland.

Mr. Wapenhans felt that the risks involved are considerable, particularly in terms of the sequencing and content of reforms. Mr. Wapenhans emphasized the importance of checking that reform implementation does occur in the short term, and pointed out that the shift from a central resource allocation system to a market driven system cannot be done in one step, and that the transition would be long. Mr. Wapenhans was also concerned about management behavior at the enterprise level and its capacity to adjust to an evolving economic environment. Mr. Wapenhans mentioned the case of Hungary, noting that substantial time is required to change behavior after decades of central management. Mr. Wapenhans stressed the importance of the IMF presence, and recommended that the program start slowly and pragmatically.

Mr. Rajagopalan considered that the paper contained strong measures and reflected the fragility of the reform program. Mr. Rajagopalan considered that the presence of the Bank and the IMF was necessary, and wondered about the timing of the Policy Committee discussion before the November 1987 referendum.

Mr. Stern agreed with Messrs. Wapenhans and Rajagopalan. Mr. Stern pointed out that Poland had announced a significant package of measures, but that its ability to hold the line remains questionable as the country would have to undergo a long program with austerity for several years. Mr. Stern then mentioned that Poland remained an uncertain borrower with a fragile political situation. There was not yet any new factor, , including recent agreements with the Paris Club, to change its 3b creditworthiness rating. Mr. Stern noted in this respect that the rescheduling at the Paris Club reflected political decisions, and not a change in the country's creditworthiness. Mr. Stern considered that a negotiated agreement with the IMF should be obtained before starting operations, and that the amount should remain symbolic. Mr. Stern also mentioned the exposure issue in the light of the current situation with other Eastern European countries such as Romania and Yugoslavia. Mr. Stern

felt that the annual program should not exceed US$250 million, and that disbursement speed should be carefully determined. Finally, Mr. Stern pointed out that Poland has the highest debt service in relation to convertible exports, and that relations with other creditors should consequently be clarified since Poland cannot rely on reschedulings and will require new money.

Mr. Shihata considered that the political sustainability of the reform program would depend on its timing and the extent of external support. Mr. Shihata felt that a symbolic intervention would not result in significant reform, and that a clear financing plan with strong creditor commitments is necessary. Mr. Shihata recommended that the IMF agreement should not be a cross conditionality, and that the decision to proceed should rely on the establishment of a firm financing plan.

Mr. Ryrie mentioned that Poland was about to join IFC, and that IFC is currently exploring possibilities including joint ventures, loan financing for cooperatives and loan financing to small enterprises. Mr. Ryrie perceived the foreign exchange risk to be a significant issue.

Mr. Thalwitz specified that the Region is seeking agreement for a first Bank operation once substantial agreement between Polish authorities and the IMF has been reached. Mr. Thalwitz requested some flexibility in the timing of the operation once it is believed that only administrative measures remain to be taken. Mr. Thalwitz emphasized the tentative nature of the US$ 800 million program.

Mr. Conable enquired about the extent to which the government was upfront in the implementation of the reform. Mr. Lari responded that a key indicator would be the extent of changes during the first months of 1988. Mr. Lari pointed out that key players were not Party members and supported rapid implementation of measures. Mr. Lari noted also that a key issue in 1982 had been that measures had not been put upfront.

Mr. Conable then requested information on the upcoming activities and timetable. Mr. Lari responded that, if there is agreement to go ahead, the Region would be processing 2 projects, would participate in a joint mission with the IMF, and would pursue preparation of future projects.

Mr. Qureshi emphasized that it was important to act in a cautious and consistent manner considering the sensitivity of the situation and the difficulty of the program. Mr. Qureshi noted that Poland was seeking through this program a new approach and credibility with the international community.

Mr. Conable concluded the discussion by agreeing with an initial lending ceiling of US$250 million per year. Mr. Conable stated that this did not imply an automatic increase of the program in later years and build up of expectations following an initial operation is to be avoided. Following the referendum, continuous analysis of the capacity to implement a reform program should be pursued.

Budget Priorities and Framework

Mr. Conable expressed serious concern about the intensity of staff requests for resources, and wondered how the current uses of resources could lead to such staff reaction. In this context, Mr. Conable considered that the mid-year review would be critical to identify the current uses of resources and areas which had benefitted from efficiency improvements. Mr. Picciotto felt that budget documents would require a more in-depth examination of efficiency improvements. Mr. Stern agreed with the revised schedule. Mr. Stern felt that the discussion with the Board should focus on choices, and that there was no consensus at this time in the Board for a budget increase. Mr. Stern recommended accordingly that an increase should be justified based not on generalities, but on the identification of two or three specific growth areas. Mr. Qureshi agreed with the time frame presented. Mr. Qureshi recommended that the attention of the Board be focused on the budgetary implications of the additional tasks which Board members expect the Bank to perform. Mr. Qureshi pointed out that the operations budget had been cut by 7.2% without including the later salary distribution cut. Mr. Wapenhans agreed with the proposed time frame, and was surprised at the firm position on a 25% ceiling on policy based lending, and the apparent openness to budget growth. Mr. Wapenhans noted that, as lending volume increases, a ceiling on policy-based lending would require additional resources to process additional project lending.

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 5, 1987

TO: Mr. Barber B. Conable

THRU: Mr. Moeen A. Qureshi, Senior Vice President, Operations

FROM: Wilfried P. Thalwitz, Vice President, EMENA

SUBJECT: POLAND - Update on Paris Club Relations

1. The evolution of relations with Poland's current creditors is a crucial factor in the substance and tactics of the Bank's program of assistance to Poland. You will recall that Poland had negotiated this summer a multi-year agreement with the commercial banks, but was still in a position of arrears with official creditors. After several failed attempts to come to agreeable terms with the Paris Club, the Polish authorities have now initialled an agreement with the Paris Club, which is scheduled to be signed formally in December 1987, with bilateral agreements required by May 1988.

2. The latest rescheduling agreement 1/ with the Paris Club consolidates arrears built up through March 1987 (with one small exception noted below) and all debt due in 1987 and 1988 (including moratorium interest for all of 1987). The IMF calculates the deal covers about $9-10 billion, or about 40% of total official exposure in Poland. The terms include five years grace plus five years repayment.

3. During the negotiations, the Polish authorities indicated that they intended to work closely with the IMF as well as the Bank. The rescheduling agreement does not include any preconditions to be met before it can be put into effect related to the IMF and its conditionality, and makes no reference

1/ The Paris Club insisted upon some up-front payment and therefore excluded from the rescheduling about 50% of the arrears on the original 1981 rescheduling agreement amounting to about $290 million, which the Polish authorities agreed to pay off in equal installments over the next four months. Payments to be made by the Polish authorities would therefore amount to $1010 million --$145 million in 1987, $735 million in 1988, and $130 million in 1989 (for moratorium interest due in 1988 on 1988 obligations which can be paid in first quarter of 1989).

Cleared with and cc: Messrs. Lari, Nouvel, Lav (EM4)

cc: Messrs Hasan, El Maaroufi (EMN); Apitz (o/r), Ramasubbu, Sood (EM4)

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to a "good will" clause about possible future reschedulings. The "good will" clause was ommitted at the request of the US, which did not wish to see references to IMF standbys at this time. In general, however, the US joined the West Germans and many other creditors to ensure that a satisfactory agreement was reached to regularize the current situation. All sides seemed content to allow this negotiation to cover an interim period during which there would be many developments affecting the conditions for potential future relations. The Polish authorities hinted that they would expect any future negotiations also to include some accommodation on interest rates.

4. The strategy of Bank assistance to help the Polish authorities to put together a credible and feasible macroeconomic and debt management plan appears to be bearing fruit. This latest agreement with the Paris Club is a major step in the implementation of the Government's plans to restore creditworthiness. The interim arrangement should provide enough time for the Polish authorities to demonstrate their capacities to pursue the reform, manage their external accounts and possibly complete discussions for an IMF standby, and thereby lay the groundwork for future reschedulings which will be needed.

The World Bank
OPERATIONS COMMITTEE

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POLAND

COUNTRY STRATEGY PAPER

Postscript to POLAND - Country Strategy Paper
Meeting held on September 22, 1987 in Conference Room E-1208

Present

Committee		Others	
Messrs.	M.A. Qureshi (Chairman)	Messrs.	T. Baudon (SVPOP)
	A. Jaycox (AFRVP)		D. Bock (DFA)
	A. Karaosmanoglu (ASIVP)		A. El Maaroufi (EMN)
	P. Loh (LAC)		D. Gustafson (CEM)
	I. Shihata (VPLEG)		R. Harris (COD)
	W. Thalwitz (EMNVP)		J. Harrison (EMN)
	D.J. Wood (VPFPR)		P. Hasan (EMN)
	J. Holsen (PPR)		T. King (EDI)
			E. Lari (EMN)
			M. Lav (EMN)
			R. Liebenthal (SPR)
			E. Nassim (CEM)
			P. Nouvel (EMN)
			G. Pohl (EAS)
			J. Prust (IMF)
			G. Reif (SPR)
			A. Steer (FRS)
			T. Thahane (SEC)
		Ms.	S. Hadler (FRS)
		Ms.	J. Loos (EMN)

POSTSCRIPT

69. This Country Strategy Paper was reviewed at a meeting of the Operations Committee chaired by Mr. Qureshi on September 22, 1987. The meeting discussed the specific measures that would need to be in place before going ahead with lending operations. The Region stated that the Polish authorities were expected to present a more detailed program of reform measures during the Annual Meetings, and noted that there was no intention to go ahead with substantial lending before significant progress had been made with a macro-economic program that would be supported by the

IMF. A representative of the IMF stated that the report on the Article IV consultations had recently been discussed by the IMF Board. The consensus was to wait until a more detailed program of action had been presented by the Polish authorities before going ahead with further discussions that could lead to a Stand-By. The Chairman noted that the Bank needs to move cautiously since Poland does not have an ongoing relationship with the Bank, and is in serious debt difficulties and has strained relations with other creditor groups.

70. The Region listed the areas in which specific and time-phased measures are expected to be presented by the Polish authorities. These include further reduction of central allocation of goods by one-half by 1988; adoption of full application of investment appraisal methodology acceptable to the Bank by 1988; further movement on adjusting the real effective exchange rate during 1988, and closely market-related exchange rate determination by 1990; substantial reduction in the scope of administrative price determination by 1990; substantial increase in interest rates during 1988, achieving positive real rates by 1990; further reduction in the rate of growth of monetary aggregates; substantial reduction in subsidies; banking reform; tax reform; and stronger external adjustment. The Region expects this program to be front-loaded, with substantial progress to be made during 1988 and 1989. A member suggested that a careful trade-off has to be made between supporting long-term reform measures that might take some time to prepare and implement, and demanding more rapid external adjustment.

71. The availability of financial resources from official creditors implied in the financing scenario of the CSP was questioned, but it was also pointed out that the projected cumulative current account deficit was rather small and that the projected Bank financing far exceeded net convertible currency resource inflows, with other creditors reducing their exposure. It was felt that the financing plan in the revised CSP should be spelled out more clearly, indicating interest, amortization, rescheduling and new money by type of creditors. A member expressed concern in particular, that the Paris Club will have difficulties accepting a workout scenario in which Western creditors will have to increase their exposure at the time when CMEA debt is being retired.

72. As to the composition of the lending program, the Region stated that structural adjustment lending was not feasible at this stage of relations between Poland and the Bank, even though the Polish authorities are expected to present, and formally commit themselves to, a reform and adjustment program that could later on be a sufficient basis for structural adjustment lending. It is thus proposed to carry out a significant part of the lending program through sectoral adjustment operations. The initial project loans are expected to be quickly disbursing and to contribute directly to increase exports, even in the energy sector.

73. It was agreed that:

(a) recent adjustment measures taken by the Polish authorities and the improved prospect for more fundamental economic adjustment and reforms provide an adequate basis to

contemplate going ahead with project lending in a modest way, keeping in mind the progress made in the relations between the Polish authorities and the IMF;

(b) an adjustment and economic reform program and an IMF Stand-By should be in place before going ahead with an expanded lending program through sectoral adjustment lending;

(c) the Country Strategy Paper should be revised to include (i) a more detailed description of the economic reform and adjustment measures proposed by the Polish authorities; (ii) a more detailed financing plan (including Paris Club, CMEA creditors, commercial banks, Bank and IMF) and discussion of the proposed burden sharing; and (iii) a clear outline of the Bank's role among Poland's creditors in the medium term;

(d) the revised CSP should be reviewed by the Policy Committee after the Annual Meetings.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: September 17, 1987

TO: Operations Committee

FROM: Enzo Grilli, Acting Director, EAS

EXTENSION: 78061

SUBJECT: Poland - Country Strategy Paper - Agenda

1. Attached is an agenda and comments on major policy issues identified by EAS for consideration by the Committee. The suggested agenda items are:

(a) Policy Conditions
(b) External Adjustment and Economic Reforms
(c) Relations with Official Creditors
(d) Composition of Proposed Lending Programs
(e) Economic and Sector Work Program

2. The Operations Committee will meet on Tuesday, September 22 at 4:00 p.m., in Room E-1208.

Attachment

cc: Messrs: Lee, Dubey (o/r), Shakow, Holsen, Rao, Baneth, Frank, Parmar, Bock, Thahane/Burmester, Lari, P. Hasan, El Maaroufi, Nouvel, Harrison, King, Lav, Loos, Liebenthal, Steer.

POLAND

COUNTRY STRATEGY PAPER

Topics for Discussion

Background

1. Poland applied to rejoin the Bank and IMF in November 1981, at a time of acute economic and political crisis. Martial Law was declared in December 1981, delaying the approval of membership until June 1986. The economic and political crisis of the early 1980s had its roots in the early 1970s when Poland started to rely heavily on imports of Western capital equipment and technology financed by foreign borrowing. Investment and consumption expanded rapidly and external debt increased from $1 billion in 1971 to $24 billion in 1979. The investment program was poorly conceived and implemented, and involved long gestation periods and extremely low returns.

2. Initial adjustment to these expansionary policies and political conflicts led to a sharp decline in output and exports in 1981, and Poland was not able to meet debt payments that reached 96% of exports in 1981. An adjustment program was introduced in 1982, reducing investment by one-half, restraining wage increases, and constraining imports administratively as well as a 50% devaluation. During the Martial Law period of 1982-83, Poland paid neither interest nor principal on its official debt, but met payments on its rescheduled debt to commercial banks. Relations with the Paris Club continue to be difficult and the Polish authorities have so far been unable to present a credible medium-term program to restore creditworthiness and sustain economic growth.

3. In 1986, the 10th Party Congress reiterated broad political support for economic reforms and urged the government to pursue the "Second State" of reform, essentially a full implementation of basic measures already legislated but not implemented. The Government presented a new Medium Term Scenario for economic reform and balance of payments adjustment to the Bank and IMF in June 1987, including tighter demand management, movement towards positive real interest rates, financial sector reform, reduction of administrative allocation, exchange rate adjustment and foreign exchange and trade system reforms, tax reform and stricter investment selection.

4. While the list of proposed reform measures contained in the Medium Term Scenario is comprehensive and impressive, these measures will have to be introduced in the face of tight balance of payments constraints in view of the precarious debt situation. There is thus extremely little room left for errors, and consistency among policy measures and appropriate timing and sequencing are thus essential.

Policy Conditions

5. The Region proposes to start lending on the basis of a "feasible and credible medium-term economic and debt management program" which would enable Poland to restore creditworthiness over time. However, the Medium-Term Scenario presented by the Polish authorities, while wide-ranging, is rather vague on specific measures. This raises a number of questions:

- What specific and monitorable measures does the Region want to see included in the program before starting any lending?
- What specific form are the agreed policy conditions to take?
- Given the adjustment problems, why does the Region propose to go ahead with a program before an upper tranche IMF facility is in place?
- Is it proposed that the Bank take the lead in a concerted effort including the IMF and other creditors, in negotiating a satisfactory program of policy actions?
- Given the past inability of the Polish authorities to implement a consistent economic reform program, what makes the Region believe that the proposed Medium Term Scenario will succeed?

External Adjustment and Economic Reforms

6. While the ratio of total debt to GDP is not unusually high (50%), the ratio of convertible currency debt to convertible currency exports is very high (5.7), reflecting a low export/GDP ratio (16%) and the fact that 90% of all debt is in convertible currencies, but only one-half of total exports are in convertible currencies.

- Why are the Polish authorities not proposing to switch more resources into export production and to re-establish creditworthiness more rapidly?

Relations with Official Creditors

7. Despite minimal net inflows from commercial banks, Poland has continued to pay interest on its commercial debt, but has failed to make payments due to Paris Club creditors who account for two-thirds of Poland's debt. The repeated failure to meet obligations on even the rescheduled amounts, while treating the commercial banks as preferred creditors, accounts at least as much for Poland's difficult relations with the Paris Club as the lack of credible medium-term program (Annex II, p. 17).

- What is Poland's strategy vis-a-vis the Paris Club?

- Would the Region consider Bank lending to Poland in the absence of an agreement with the Paris Club as suggested in para. 55?

- Is it appropriate for the Bank to lend extensively to Poland before a more equitable burden sharing has been agreed?

Composition of the Proposed Lending Program

8. While the main problems in Poland appear to be external adjustment and rather fundamental economic reforms, the Region proposes a lending program based largely on project lending in industry, energy and agroprocessing, with a possibility of policy-based lending operations only in the outer years. Nevertheless, it is envisaged to increase lending rapidly from $250 million in FY88, to $500-800 million in FY89-92. While it is argued that initial projects would assist in removing bottlenecks, this argument does not appear fully convincing, as Poland is suffering from too many infrastructure, energy and heavy industry projects with low returns.

- Is there any justification for extensive project lending in view of the present economic situation?

- Would it be preferable instead to have a very low project-based lending program (say two $50 million projects per year) and make additional resources available through policy-based operations, conditioned on progress in implementing the reform and adjustment program? ?

- Why is the proposed lending program not geared more towards sectors that are essential for increased exports (light industry, agroprocessing)?

Economic and Sector Work Program

- Given the wide-ranging economic reform program envisaged, how does the Region want to orient its ESW program, and what are the trade-offs between economic work in support of reform measures and resources that would be required for project preparation?

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 5, 1987

TO: Mr. Barber B. Conable

THRU: Mr. Moeen A. Qureshi, Senior Vice President, Operations

FROM: Wilfried P. Thalwitz, Vice President, EMENA

SUBJECT: POLAND - Update on Paris Club Relations

1. The evolution of relations with Poland's current creditors is a crucial factor in the substance and tactics of the Bank's program of assistance to Poland. You will recall that Poland had negotiated this summer a multi-year agreement with the commercial banks, but was still in a position of arrears with official creditors. After several failed attempts to come to agreeable terms with the Paris Club, the Polish authorities have now initialled an agreement with the Paris Club, which is scheduled to be signed formally in December 1987, with bilateral agreements required by May 1988.

2. The latest rescheduling agreement 1/ with the Paris Club consolidates arrears built up through March 1987 (with one small exception noted below) and all debt due in 1987 and 1988 (including moratorium interest for all of 1987). The IMF calculates the deal covers about $9-10 billion, or about 40% of total official exposure in Poland. The terms include five years grace plus five years repayment.

3. During the negotiations, the Polish authorities indicated that they intended to work closely with the IMF as well as the Bank. The rescheduling agreement does not include any preconditions to be met before it can be put into effect related to the IMF and its conditionality, and makes no reference

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Cleared with and cc: Messrs. Lari, Nouvel, Lav (EM4)

cc: Messrs Hasan, El Maaroufi (EMN); Apitz (o/r), Ramasubbu, Sood (EM4)

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to a "good will" clause about possible future reschedulings. The "good will" clause was ommitted at the request of the US, which did not wish to see references to IMF standbys at this time. In general, however, the US joined the West Germans and many other creditors to ensure that a satisfactory agreement was reached to regularize the current situation. All sides seemed content to allow this negotiation to cover an interim period during which there would be many developments affecting the conditions for potential future relations. The Polish authorities hinted that they would expect any future negotiations also to include some accommodation on interest rates.

4. The strategy of Bank assistance to help the Polish authorities to put together a credible and feasible macroeconomic and debt management plan appears to be bearing fruit. This latest agreement with the Paris Club is a major step in the implementation of the Government's plans to restore creditworthiness. The interim arrangement should provide enough time for the Polish authorities to demonstrate their capacities to pursue the reform, manage their external accounts and possibly complete discussions for an IMF standby, and thereby lay the groundwork for future reschedulings which will be needed.

OFFICE MEMORANDUM

DATE: November 12, 1987

TO: Mr. Moeen A. Qureshi, Senior Vice President, SVPOP

FROM: Mr. Wilfried P. Thalwitz, Vice President, EMENA

SUBJECT: POLAND - Country Strategy Paper

1. Attached is an updated Poland Country Strategy Paper (CSP) for distribution to the Policy Committee, for consideration at its November 25, 1987 meeting. We have revised the CSP to reflect the Operations Committee comments and to incorporate the most recent developments in Poland and in Paris Club negotiations. We also took the opportunity of this update to rerun the economic and financial analysis based on the recently revised Bank price indexes.

2. For ease of reference, you may wish to note that the most important revisions have been made in the following paragraphs: (i) Conclusions and Recommendations; (ii) more detailed description of the proposed economic reform and adjustment measures in paras 14-19; (iii) external support in paras 32-33, 35; (iv) macroeconomic prospects and financing plans in paras 36-47; and (v) strategy and risks in paras 49, 51-55, and 57.

cc: Messrs. Dubey (EAS); P. Hasan, El Maaroufi (EMNVP), Lari (EM4);
Nouvel, Harrison, Lav, Ms. Loos (EM4CO)

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POLAND

Country Strategy Paper

CONCLUSIONS AND RECOMMENDATIONS

i. Background and Summary Diagnosis. The Polish authorities face major developmental issues--implementation of the reform of the centrally planned economic management system to more market-oriented principles; restructuring of an outmoded production base; and regularizing relations with current creditors. While the Government's official Five Year Plan (1986-90) did not provide an acceptable path to restore creditworthiness and lay the basis for sustained long-term growth, it has been superceded by a revised medium-term Scenario which clearly recognizes the need for a dynamic export sector, makes more realistic assessment of import needs, and outlines implementation plans for the reform program. The revised Scenario presents a feasible macroeconomic framework, addresses key issues, and is being fleshed out with considerable up-front actions and a time-bound implementation program. See para 18 of text for a summary of the important policy measures and systemic improvements presented so far. The Scenario also envisions continued rescheduling of current debt, resumption of lending from Poland's current creditors, and financial and technical support from the IMF and the Bank.

ii. While we find the Government's proposals to be satisfactory for the most part, there are some areas in which we consider more work to be required and are pursuing these discussions. We have found no great difference of view between the Polish authorities and ourselves about the source of Poland's economic difficulties and the possible prescriptions to deal with them; where we may differ is on the possible speed of the adjustment process for the external accounts. (Note that Poland's convertible currency medium- and long-term debt is not exceptionally large when related to output--$33 billion at end 1986, or 43% of GDP, but is five times larger than Poland's annual convertible currency exports.) The Government's current plans call for a return to current account balance by 1991 (two years earlier than previous plans), but we consider it desirable and possible to accelerate this into 1990. The Government's plans for national income and consumption growth are not austere and there should be some room to reduce these to attain a more rapid adjustment on external accounts.

iii. Success in addressing the developmental issues will require strong political commitment and improved co-ordination within the Government. Implementation of such major reforms is a daunting task, and one for which there are few successful precedents. It must be recognized that Polish economic management has been weak in the past and previous Governments have only haltingly implemented past reform measures. Futhermore, the current Government will face increasing difficulties with its administrative structures as it breaks up long-standing sinecures and bureaucratic powers, as well as a very skeptical and risk-adverse population.

iv. There is a wide range of political opinion in Poland (e.g., Catholic Church, pro-Solidarity groups) and a fair degree of openness in the political dialogue with these forces, which--while critical of the Government--have publicly supported many of the objectives of the reform program. They see the economic reform program and further economic liberalization increasing the chances for political response. In fact, moves on both the economic and political fronts have taken place in the past 18 months, a consequence of a strengthened dialogue internally and externally and of an increasingly supportive external environment (East and West).

v. A positive sign is the Government's decision to hold a referendum at the end of November on its plans for implementing the reform program, which includes major administrative, social and economic system changes. Through this unusual maneuver, the Polish authorities are seeking to consolidate popular support for the further measures they will need to take, many of which will necessarily have an adverse impact on parts of the population. Another hopeful sign is the strong endorsement of the revised Scenario and the overall reform program not only by the Prime Minister and the agencies clearly aligned with the reform (National Bank and Ministry of Foreign Trade), but also by the Planning Commission, which led the opposition to reforms in the past.

vi. A risk in the Government's program is that the export-led strategy may encounter more difficulties than foreseen, both internally and externally. We have carefully evaluated Poland's export prospects and consider the sustained growth rate of about 7% per annum to be feasible, although far from easy. Concerning markets, we are reassured by the fact that Poland is not a major supplier in most target markets and it will, in fact, take a significant increase in exports to regain market shares lost in the early 1980s.

vii. Another uncertainty is whether the program will elicit the type of international support required. The Polish program implies a relatively small and temporary net increase in debt between 1987 and 1990, after which the debt would gradually decline. At the same time, Poland would be making interest payments of about $2.5 billion per year. This major effort would need support in the form of continued rescheduling of existing maturities and the presence of the IMF and the Bank would both facilitate this rescheduling and provide additional resources. The response from creditors so far has been encouraging, with both the commercial banks and the Paris Club recently completing arrangements in principle for major reschedulings (covering nearly all commercial and about 40% of official debt). Relations with the IMF remain tentative, although Poland has repeatedly indicated its desire to initiate discussions of a framework for a standby arrangement. The IMF is fielding a mission to Poland in November to update information on the reform, following-up their Board consideration of the Article IV consultation in September 1987. However, there is a danger that, if external financial support is not forthcoming for the ambitious program of reform, adjustment and growth, Poland would continue to be unable to meet its current obligations and may slow down its market-oriented reform, an alternative neither the Polish authorities nor we consider desirable, as it would have evident adverse economic and political consequences.

viii. Finally, it must be recognized that even after the envisaged reschedulings and new borrowings abroad, Poland's creditworthiness will remain fragile for years to come, and critically depend on steadfast economic policies at home and a favorable environment both domestically and abroad--features which have been noticeably absent in Poland's recent past. Of special importance will be: (i) the country's success in rapidly generating a surplus in the current account of its balance of payments and thus effect increasing transfers of resources abroad and reduce substantially its external debt; (ii) the restructuring of Poland's external debt and new capital inflows to allow the country to devote more resources to modernize and expand its productive capacity without resorting to a politically unacceptable compression of living standards; and (iii) a parallel process of political liberalization necessary to develop and consolidate support for the economic reform both domestically and abroad. The apparent determination of the Government to promote the economic reform and, however timidly, a modicum of political liberalization as well, and the recent rescheduling agreements with the commercial banks and the Paris Club--in a much improved and promising atmosphere--increase the chances of success.

ix. Proposed Bank Strategy. The Polish authorities have cooperated fully with the Bank and engaged in indepth discussions of a wide range of development issues and policy options. Despite the constraints and the extremely difficult task facing the Government to design and implement its programs, significant progress has been made over the past year. The dynamics of the process are growing stronger, cumulative and in the right direction. We have received confirmation from the highest levels of Government of its wish to work constructively with the Bank; the Government is distributing the first Country Economic Memorandum widely in Poland. We recommend that the Bank continue to play an important role in helping the Polish authorities finalize and implement a credible program which shows how the reform would be implemented and the economy restructured and how they would restore creditworthiness. Although such a plan must clearly be a Polish product, as the political choices and trade-offs are theirs to make, they have gratefully acknowledged our input to date in helping them see new possibilities and improve their own work.

x. We recommend that the Bank make all preparations necessary to be ready to initiate lending in late FY88, and thus formally support the Government's recovery program. We would monitor developments and progress in implementing the Government's plans and the process of regularizing relations with current creditors, before inviting formal loan negotiations to ensure that the overall program is progressing satisfactorily and the underlying financing plans are viable. We have scheduled appraisal of two projects in the second quarter of FY88. We also recommend making a PPF available to the Government to facilitate project preparation, including some technical assistance and training urgently needed to upgrade potential intermediaries for the first projects.

xi. We propose to initiate lending at a level of about $250-300 million in FY88 via activities in the industry, energy and agro-processing sectors which would increase the convertible currency trade surplus. Lending at this level represents about one third of that for which Poland could theoretically

be eligible, given the size of its economy (1986 GDP $74 billion, 37 million people). We suggest taking this modest approach, keeping in mind the need to make a significant contribution to assist the Polish authorities to undertake the necessary measures to restore overall creditworthiness, while at the same time recognizing the inherent risks. Lending at a lower level would not be sufficient to have a serious impact on the sectors being assisted, to demonstrate to Poland and its creditors our confidence in the reform, nor to maintain and further develop the rich policy dialogue that we have had so far.

xii. Project selection focusses on those foreign exchange expenditures which can be shown to have a direct and immediate effect on export capacity, such as debottlenecking investments, working capital to finance imported inputs, raw material, spares, etc. Through this bottom-up approach, we also expect to strengthen the reform, because policy measures and administrative reforms have significance only through their impact on actual economic and financial decision-making at the enterprise level and need understanding and support from below. These first operations would be fairly straightforward, justified in themselves by their own contribution to efficient export expansion, and supported by the Bank to uphold the major efforts the Government is making to restore creditworthiness.

xiii. Assuming that there is good progress on the reform and recovery path and satisfactory relations with current creditors, we propose to move in the next few years toward a combination of policy and investment lending directed at sectoral restructuring programs. The basic macroeconomic conditionality relating to progress in implementing the Government's program would be agreed as part of overall understandings between the Government and the Bank. Economic and sector work would help develop and expand the restructuring and reform programs, with the scale and timing of the lending program based on the progress already made. Both policy/investment and standard types of projects would make interesting vehicles for possible cofinancing. We would also be prepared to move toward a lending program with significant policy-based lending instruments over time. The lending program is therefore tentatively geared to build up to $800 million per year.

xiv. Policy Conditionalities. The conditions for initiation of lending in FY88 would be that the Government has prepared what we consider to be a credible medium-term economic and debt management program (including detailed, front-loaded and time-bound implementation plans) which would enable Poland to restore creditworthiness over time. We would monitor the Government's implementation results as well as the progress made in relations with official creditors and the IMF, and would propose to send projects to the Board only once Poland has established, or there is at least a firm prospect of Poland establishing in the very near future, satisfactory relations with its current creditors and the IMF. Key parts of such a program would be: effective demand management (including reducing the rate of credit expansion, establishing positive real interest rates, removing producer subsidies in key sectors, wage policy linked to productivity); appropriate decontrol of pricing; application of appropriate methodology for evaluation of investment proposals; phased program for elimination of central allocation of materials; active exchange rate management; and reduction in the share of foreign exchange allocated by central administration and rationalization of export incentives. We would also press the Government to endeavor to reach equilibrium in the convertible currency current account of the balance of payments earlier than the currently projected target of 1991.

xv. The Government's program would be reviewed annually and we would agree with the Polish authorities on a sequencing and timetable for key parts of their program, satisfactory action on which would be necessary to trigger each subsequent group of annual lending operations.

xvi. <u>Time Schedule for Next Review</u>: 1 year

I. BACKGROUND

Country Economic and Policy Status

1. Poland was a founding member of the World Bank, but withdrew in 1950. It applied to rejoin the Bank and the IMF in November 1981, at a time of acute crisis in both its macroeconomic balances and external debt. Before action was taken on its membership, Martial Law was declared. Western reactions included explicit opposition to IMF (and therefore Bank) membership. Eventually, the Bank Governors approved Polish membership in June 1986.

2. The economic and political crisis of the early 1980s had its roots in the early 1970s, when a radical change of policy led Poland to undertake a program of economic modernization that relied heavily on imports of Western capital equipment and technology, financed by foreign credits. At the same time, in order to defuse social tensions and promote higher labor productivity, wage restraints were relaxed. An extremely rapid growth in investment and consumption ensued, which was accompanied by an unprecedented upsurge in imports from convertible currency areas. External financing was readily available during this period, and external debt mounted quickly, growing from $1.1 billion equivalent in 1971 to $12 billion in 1976, and to $24 billion in 1979.

3. As it began to be evident that the Government's investment strategy would not yield the expected results (in particular increased exports to service debt), the Government took a number of measures in the late 1970s to attempt to deal with the growing imbalances. Nonetheless, the economic situation weakened rapidly and the rate of growth of output slowed, and turned negative in 1979 for the first time in the post-war period. Domestically, results of the previous macroeconomic policies and the growing conflict between the independent trade union movement and the Government led to significant losses in output and exports. Externally, net medium- and long-term capital flows fell precipitously. To face these mounting pressures, the Government declared Martial Law in December 1981, launched a stabilization program, and initiated a reform of the economic system.

4. The stabilization program began in 1982 and included strong and comprehensive measures--total output and real wages fell by a quarter, investment was halved, domestic prices doubled, and the zloty was devalued by more than 50%. Poland achieved a substantial trade surplus with the convertible currency area by severely constraining imports. The adjustment on the convertible account for the 1975-85 period amounted to about 8.5% of GDP. During this period, the nonconvertible current account remained relatively stable and in deficit, equivalent to about 2% of GDP.

5. Recovery from the crisis has been gradual. Output growth did resume in 1983, but total output by end 1986 was only about 90% of its 1978 peak. Fixed investment stabilized at about 20-25% of GDP, but still includes a large overhang of unfinished projects. Internal balances improved, with rationing eliminated for most consumer goods and the scope of central allocation of materials progressively being reduced as well. However, shortages persist and convertible currency exports have not regained market shares lost in the 1980-82 period.

6. External debt management has been a major problem. (See Annex I for history of Poland's convertible currency debt.) The crux of the debt issue lies in the fact that, while Poland's convertible currency debt is not exceptionally large when related to output (about $33 billion at end 1986 or 43% of GDP at current exchange rates), it is five times larger than Poland's annual convertible currency exports. Despite such structural constraints and political difficulties in relations with Paris Club members [1] (especially during the period of Martial Law), Poland has not denied its responsibilities and in fact has consistently indicated its intention to meet fully its financial obligations over time.

7. By the beginning of the 1980s, debt service due was about 155% of exports and Poland turned to rescheduling. Poland paid debt service during the period 1982-86 of amounts equal to about one third of exports of goods and non-factor services. Despite the fact that Poland made interest payments equivalent to about $7 billion and repayments of about $2.7 billion during the 1982-86 period, there has been no new term lending to Poland since 1982. Even after reschedulings, Poland was not able to make full payments of the amounts owed and arrears built up to Paris Club creditors. Unlike Baker Plan countries, nearly two-thirds of Poland's debt is held by official creditors, and Poland is one of the largest debtors of the Paris Club. Poland has successfully arranged reschedulings with the commercial banks and has been making full interest payments to them. The commercial banks also arranged a small revolving trade credit for Poland, but for the most part, Poland paid cash for nearly all imports since 1981. Polish commercial debt sells at a discount of about 55%.

8. Simultaneously with the stabilization, the Government introduced a major reform of the economic management system. The reform program, introduced in 1982, attempted to increase the role of market mechanisms by: (i) increasing autonomy and accountability of enterprises to foster greater material and labor efficiency, and (ii) streamlining centralized management to work by indicative planning and policy prescription rather than by direct command. Significant changes which have been introduced include: the rapid growth and greater security of the private sector; the considerable reduction of the scope of central control; the growth of markets through the extension of contractual and international prices; the partial liberalization of employment and wages; initial steps in developing an independent banking system; the articulation of fiscal policies to regulate the economy through policy instruments; and the modest but tangible progress in enterprise self-management compared to the traditional centrally-planned economy model.

9. The economic and socio/political crisis inhibited the central authorities from fully pursuing many of the reform measures. Even after the stabilization subsided, implementation of reform measures has not proceeded as planned. There has been a good deal of public discussion of the reform and how fast it should be implemented, with the debate about what would make "market socialism" work in Poland being conducted on fairly pragmatic grounds of what is feasible, necessary, inter-linked, etc., and not on questions of ideology. It is not unimportant that the Soviet Union is now also looking to find ways to improve the efficiency of its system, including considering some measures which the Polish authorities legislated in the early 1980s.

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[1] The largest official creditors in the Paris Club are: FRG 22%, France 14%, Austria 14%, USA 10%, and Brazil 9%.

10. Although there continues to be a wide range of political opinion in Poland which is severely critical of the Government (e.g., Catholic Church and pro-Solidarity groups), even these forces have publicly supported many of the objectives of the reform program. Nonetheless, the Government is likely to face increasing difficulties with the general public and the bureaucracy/party structures as it tries to pursue an economic reform program which reduces income growth rates and breaks up long-standing sinecures and bureaucratic powers. Four out of the last five attempts to make a major realignment of prices resulted in changes of leadership and/or reversals of policies; only under Martial Law have major relative price adjustments been made. To its credit, the Government is taking steps to develop a social consensus for such measures, but it is intensely aware of its low credibility and limited room for maneuver in the face of social pressures.

11. The macroeconomic scenario originally prepared in conjunction with the official 1986-90 Plan projected modest goals and assumed no change in Poland's economic relations with the convertible currency areas (i.e., no new loans and continued reschedulings and capitalization of interest arrears). Material output was to reattain its 1978 level only by 1990. Balancing the current account was not a fundamental objective and external debt would continue to increase simply through the involuntary capitalization of interest arrears to official creditors. For the convertible currency accounts, a positive current account balance was projected only in 1993, despite unrealistically low import elasticities. In contrast, the trade balance with the CMEA area was to improve substantially, with Poland to stop running a trade deficit with the CMEA area in 1988, begin to generate a current account surplus and repay CMEA debt nonconvertible (total equivalent to about $4.6 billion).

12. By mid-1986, it was clear that, although there had been considerable improvement, the process of reform and recovery had bogged down. The 10th Party Congress reiterated broad political support for the reform and urged the Government to pursue what is called the "second stage" of the reform, essentially the full implementation of the basic measures already legislated. The shortcomings of the official Plan scenario and its operating assumptions became a central focus of the Bank's dialogue with the Polish authorities. These discussions combined with the important changes in international economic relations (including membership in the IMF and World Bank), and a realization that a better export performance was possible, led the authorities to revise the official medium-term program and the related macroeconomic projections in June 1987.

13. The <u>revised medium-term Scenario</u> was officially presented to the Bank and the IMF as the Government's revised position in early July 1987. We consider the revised Scenario to be an important step forward on a number of fronts--it is an important document defining the course of action to be followed to implement the reform; it validates the expectation that our consultations/advice over the past year could assist the Polish authorities to consider new possibilities; it responds to IMF criticisms and therefore sustains that dialogue which appeared to be waning in the past year; and it provides a medium-term framework for expanding the scope of negotiations with the Paris Club.

14. The revised Scenario covers a wide range of important issues and the macroeconomic forecasts appear feasible. In macroeconomic terms, the revised Scenario is based on the following: (i) the low end of the ranges included

in the official Plan for growth of domestic consumption (2.4% per year overall or about 1.6% per capita) and national income (3.1% per year), which are seen as politically the most sensitive for its acceptance; (ii) lower investment growth and higher export growth to convertible currency areas; (iii) more realistic import elasticities (and therefore higher import levels); and (iv) a more efficient use of imports for investment and production goods as opposed to consumption. The revised balance of payments projections show steady improvement in the current account, a substantial improvement over earlier projections which had shown all improvement in the outer years. The revised Scenario would yield a current account balance in 1991, two years sooner than previous forecasts. It would still be necessary to restructure existing debt, and some fresh medium- and long- term lending would be required. Total debt would continue to grow, but stabilize at about $37b, before being progressively reduced after 1992.

15. The Polish authorities launched several working groups from the relevant ministries/agencies to work under the direction of the Deputy Prime Minister for Reform to develop more fully the overall reform program and flesh out the detailed implementation plans. The plans include major reforms in the administrative and social/political structures, as well as measures to improve the economic system, and have been codified into a detailed timetable of 120 measures to be carried out essentially over the next two years. Examples include: the Planning Commission being reoriented to strategic work and released from day to day oversight of the management of the economy; the number of ministries reduced by nearly half and the various ministries dealing with industry consolidated into a single ministry with curtailed powers to intervene in enterprise matters; the number of firms with Government-nominated boards would be reduced from 1300 to 400; liberalizing procedures to obtain licenses for foreign trade operations; revising the system of subsidies in the food sector; updating regulations and system of financial accounting for building/assembly work to improve incentives for rapid project completion; introduction of regulations necessary to allow leasing of spare production capacity in socialized enterprises; changes in the labor code to favor greater labor efficiency; revising enterprise accounting principles; and expanding the scope and autonomy of local authorities. Also, the tax system would be revised in the next two years with the introduction of a VAT.

16. The Government's program is made up of three parts, which constitute blocks of actions aimed at reaching the three basic goals: (i) bringing the economy to balance through stimulating the growth of supply; (ii) bringing the economy to balance through strengthening of the domestic currency and changing the structure of relative prices and incomes; and (iii) changing the system of management of the economy. The phasing of measures is intended to yield the following:

1987 a fundamental change in the functional terms of reference and organizational structure of the central economic administration

1988 a marked step forward in balancing the domestic economy, introducing major changes in relative prices, increasing the role of the market and increasing pro-export orientation;

1989 further approaching economic equilibrium, including progress in restructuring prices and incomes policy, stabilizing the exchange rate and bringing order to the wage systems;

1990 attaining domestic equilibrium and slowing down the rate of inflation to about 9% annually;

1991 balancing the current account of the balance of payments and laying the groundwork for reducing debt.

17. These plans have now been officially presented to Parliament for information purposes, and the Deputy Prime Minister for Reform was appointed to head the Planning Commission. A referendum on the reform will be held at the end of November to consolidate popular support for the reform program. Through this unusual maneuver, the Government is seeking to establish a political consensus to pursue the detailed measures, many of which will necessarily have an adverse impact on parts of the population. Although the reform was officially and strongly endorsed at the highest political levels, some outside observers think that hardliners within the party and Government may have agreed to the referendum in the hopes that the population would reject the high price tag of reform, and therefore plan to use that occasion to reassert themselves and demonstrate to Western creditors the limits of what Poland can be expected to do.

18. The Government presented to the Bank at the recent Annual Meetings an outline of these implementation plans; they did not update the macroeconomic and debt management scenarios pending the Paris Club discussions in late October. We reviewed the key measures which underpin the revised Scenario and found them acceptable for the most part. A major milepost in implementing the reform program will be the annual plan and budget for 1988, which are being prepared now, and will establish the pace of key actions on pricing, subsidies, and investment policies. Important policy measures and systemic improvements presented so far are:

(a) tighter demand management, including more disciplined budget policies for Government and enterprises; overall level of budget subsidies to be maintained at current nominal level through 1990 (implying reduction of about 50% in real terms);

(b) introduce more realistic relative price structure, including major price increases and substantial removal of producer subsidies in key sectors in January 1988 (especially energy) with final adjustments to be completed by 1990; and review of consumer subsidies, with a view to reducing and better targetting them.

(c) constrain growth of bank credit to growth rate of real income plus 1/2 target inflation rate in 1988; increasing lending rates in 1988 from an average of 7% to about 15%, and moving progressively towards positive real interest rates (accompanied by a reform of the banking system);

(d) Application of improved methodology for evaluation of investments, including re-evaluating some large on-going investments of dubious merit by January 1988.

(e) Phased elimination of the central allocation of materials (except energy) to be completed by 1990, reducing the number of centrally allocated materials by half in 1988.

(f) Active foreign exchange management; developing/implementing a more market-oriented approach, including setting the exchange rate level in 1990/91 at a level consistent with balance of payments equilibrium, with limited central allocation of foreign exchange.

(g) Reduction of share of foreign exchange allocated by central administration and increase share retained by exporters; eliminate Price Equalization Scheme in 1988 and further rationalize export incentives.

(h) Attainment of a balance in the convertible currency current account (no later than 1991).

19. Areas about which we expect to have further discussion are the pricing system and aspects of macroeconomic management, including the pace of adjustment of interest rates and limiting bank credit and monetary creation. Concerning prices, substantial changes in the relative price structure are proposed by January 1988, which will have an important impact on allocative efficiency. Some improvements in the system by which prices are established are also part of the reform program, including abolishing regulated prices (which account for about 2% of turnover), utilizing border prices for the domestic prices of internationally trade goods, and no longer requiring enterprises to calculate their prices on the basis of "substantiated cost." However, we remain concerned about the large number of administratively determined prices, for which the Government will set ceilings for annual increases. Thus, while the structure of relative prices will improve in 1988, market forces will not be fully free to determine futher adjustments in relative prices. A carefully planned program to decontrol the pricing system will be an essential complement to the relative price adjustments now planned; both pricing measures will be important to obtain the full effects of the planned reduction in central allocation of materials.

Bank Relations

20. The development of the Bank's relationship with Poland has proceeded very well. The Polish authorities have cooperated fully with the Bank, provided all information requested, and engaged in indepth discussions of a wide range of development issues and policy options. We have received confirmation from the highest levels of Government of its wish to work constructively with the Bank and the Government has indeed moved more quickly on some major policy initiatives than we had originally expected.

21. Our major work undertaken to date consists of two economic reports--a first informal economic report which was completed in early September 1986 and discussed with the Government in October, 1986; and the Country Economic Memorandum (CEM) which was distributed to the Board on August 17, 1987 and recently reprinted in the series available to the public. The first report was directed at two issues: per capita income and the debt problem. We were able to verify that Poland was eligible for Bank lending, with an income level of $2050 (1987 WDR, 1985 GNP per capita). As to the debt problem, we concluded that it was not insurmountable, but found that the Government was pursuing a program which would not enable them to become creditworthy in the foreseeable future; moreover, the Government's plans would not enable them to lay the basis for sustained long-term growth. The work on the CEM further developed discussions with the Government about ways to improve its development plans and put together a program for accelerating both the reform and the process of external adjustment.

22. We have also undertaken other tasks as part of the startup of relations, including contacts with the Paris Club and commercial creditors, agreeing with the Polish authorities on how to handle debt reporting, satisfactory collaboration with the IMF, and introducing the Polish authorities to the Bank's way of conducting business through special seminars in Poland and Polish attendance at Bank-sponsored seminars elsewhere. We also initiated identification and preparation work for projects in industrial exports, agro-processing and energy sectors, two of which we are about to appraise.

II. Central Development Issues

23. Poland's central development challenge is to reach a sustainable growth path which would strengthen the economy's ability to compete in world markets and improve living standards at home while meeting its external debt burden. The Polish authorities face formidable constraints. These derive from the fact that the centrally-planned economic system utilized for the past 40 years is not operating satisfactorily, as it is not producing what is needed at a reasonable cost and is not able to bring about improvements in efficiency. The Polish authorities approach this situation with the understanding (and outlook) that Poland requires a more fundamental adjustment than merely shifting sufficient resources from domestic absorption to balance the current account or increased imports of updated technology. The fundamental issues are: (i) the need to reform the economic management system to enable the economy to produce more efficiently; (ii) the need to restructure the outmoded production base in industry, agriculture and energy; and (iii) the need to regularize relations with current creditors.

24. The Government faces very difficult conceptual issues in the design of the reform and in the management of its implementation, which require substantial improvements in the definition, co-ordination and implementation of economic policy. These issues are strongly inter-related and there are potential short-run conflicts among them. The Polish authorities clearly see the regularization of external accounts as a means to a larger end and not an objective in itself. Another conflict is seen in the realization that it would be possible to bring about a faster physical restructuring of some parts of the productive sectors through stronger central controls, but this would be antithetical to improving the long-run efficiency of the economic system. The political objectives of maintaining full employment and increasing consumption also conflict with the goals of increasing efficiency and exports.

The Reform

25. Any reform package that has a reasonable chance to succeed in Poland will need to address issues in demand management, the trade regime, resource allocation systems, fiscal systems, and financial sector, in addition to a range of sectoral issues. There are several other vitally important and mutually reinforcing elements of economic policy: a careful reduction in the investment program to improve its overall efficiency and initiate new and more productive investment; and the restructuring of the productive base and improvement of factor markets to allow resources to be used where they contribute most to national income.

26. The fundamental nature of the reform proposals means that co-ordinated implementation and appropriate sequencing are exceptionally important. In developing with Government the tactics for sequencing of the reforms, we are discussing the following principles. The first stage could have four components. First, reduce further the role of Government in the central allocation of goods, which would be necessary to allow price incentives to work. A second component would be to establish an appropriate demand management framework, without which other measures would be self-defeating. Third, improved project selection criteria by the Government to avoid further waste of resources. The fourth component would focus on introducing a set of relative prices throughout the economy which would reflect world prices, so that resources would be used more efficiently given existing productive facilities. The second stage would focus on improving factor mobility and the incentives to allocate capital and labor to more efficient uses. The third stage, for which substantial preparation would be necessary, would be to improve the institutional framework in key areas, particularly finance and the banking system to further promote capital mobility.

Restructuring of Productive Sectors

27. (See Annex II for a more detailed description of major sectors.) The industrial secor (comprising, according to the Polish definition, mining, energy as well as manufacturing) has been the leading sector of the national economy since 1960. Currently it contributes about 50% of net material product and employs 29% of the labor force. Industrial exports have maintained a predominant share in total exports (90% in 1986), of which about 46% were directed to convertible currency markets. The energy sector and the investment program for electric power and heat production are at a critical stage. Hard coal is the largest export, but there is very little room to increase productivity in existing mines and new mines coming on stream in the next five years or so will just compensate for old capacity being depleted or shut down. Domestic energy consumption continues to absorb growing proportions of production, limiting the amount of hard coal available for export. When compared to international standards, Poland's use of energy is inefficient, both in terms of production (e.g., generation plants producing at lower than rated capacity and high transmission losses) and utilization (e.g., continued use of wet-process for cement manufacture). An intensified energy conservation program is essential both to lower domestic production costs and to free hard coal for export. Work has been initiated, with Bank and UNDP support, to help clarify the likely responses to the introduction of adequate energy pricing, as well linkages to different aggregate demand growth scenarios, both of which will be important factors in defining the investment needs of the energy sector.

28. The low level of material and labor efficiency in manufacturing is also of concern. Poland's major comparative advantages lie in its low labor cost and high level of skills and industrial experience; however, Poland's industrial structure is heavily capital-intensive and the investment program continues to reflect this bias. Industrial capacity utilization ranges widely; this has been ascribed to the lack of foreign exchange for spare parts and repairs, but is also the consequence of poor linkages between companies and subsectors. There are also many cases of plants designed at sub-optimal scale, which therefore cannot operate efficiently. Weak financial and economic management at the enterprise level undermines performance of the sector. Most enterprises do not have adequate marketing skills, which are especially important for reaching international markets.

29. The agriculture sector is mainly in private hands and contributes about 16% of GDP, but employs about 30% of the labor force; only about 5% of agricultural production is exported. Yields are relatively low and stagnant, with Poland falling progressively further behind even its Eastern European neighbors. The climate is not ideal, but certainly not a severely limiting constraint. Although Poland's level of modern input use and mechanization compares favorably with its neighbors, yields do not. Poland is acknowledged to have a strong agriculture science base, with perhaps the best trained scientists in the Eastern Bloc, but systemic and institutional difficulties (extension, credit, marketing) impede the large private sector from benefitting from this advantage.

30. Poland also lacks a good intermediation system to reinforce sound investment selection and enforce financial discipline. Financing decisions tend to be made in conjunction with the other centralized decisions, affording little authority to the banks to make independent judgements. Enterprise investments and operations are protected from the consequences of their mistakes through major transfers from the state budget, price controls and the monopolistic structure of production. Lending rates are currently substantially negative in real terms.

31. The deteriorating environment is also an important structural issue. Poland's environment is considered among the worst in the world, with air, water and soil pollution threatening crop production, health, water supplies, buildings, forests and tourism. Sulphur dioxide is the single worst pollutant, caused by the burning of low-quality coal.

External Support

32. The third major issue for Poland's development prospects is the nature and level of outside support. As noted above, the balance of payments forecasts indicate that Poland will continue to need large-scale reschedulings of its current debt, plus flows of new money to support the increased import content of the recovery plan. The Government's revised Scenario calls for total rescheduling during the 1988-92 period of about $18 billion, plus new money of about $5 billion (of which about $2 billion would be a net increase in debt). (Note however that the Government's plans also call for interest payments of about $2.5-3 billion per year, far more than the net increase in debt, indicating a significant transfer of resources out of Poland--unlike the debt restructuring agreements currently being negotiated with other large debtors.) Whether this type of outside support can be attained is uncertain, but recent developments are encouraging.

33. Polish relations with the Paris Club have been difficult in the past, in particular during the period of martial law. However, part of the past difficulties must also be ascribed to the inadequacy of the Polish approach, and its failure to make agreed payments and its reluctance to make counter-offers and negotiate. After several unsuccessful attempts to come to agreement with the Paris Club since the last rescheduling covering 1985 payments, they initialled an agreement in late October 1987 covering all interest arrears through March 1987, moratorium interest during 1987, and all debt coming due through December 1988 (about US$9-10 billion, or equivalent to about 40% of Poland's official debt). The terms are for 10 years, including 5 years of grace. While this rescheduling is not the major multi-year rescheduling which some parties in Poland had hoped for, it is the first time the Paris Club has agreed to more than the regularization of

arrears. The rescheduling agreement does not include any preconditions to be met before it can be put into effect related to the IMF and its conditionality, and makes no reference to possible future reschedulings. All sides seemed content to allow this negotiation to cover an interim period during which would occur many developments affecting prospects and conditions for potential future agreements.

34. Current agreements with the commercial banks cover debt coming due in 1986-87 and the commercial banks agreed in principle in late August 1987 to reschedule nearly all outstanding debt (about $8 billion) over 15 years, with some concessions to lower the interest rate as well. The terms also include some small payments of principal. An interesting feature is its division into two phases, with the second phase being put in force after Poland has achieved a standby arrangement with the IMF, but this second phase starts only in 1991, providing a relatively long lead-time.

35. The IMF Board reviewed the latest Article IV Consultation Report in mid September 1987. The Polish program received a broad measure of support, in particular from European chairs, but a rather cool response from the US, which cautioned the IMF about moving too fast towards a standby arrangement. In his wrap-up, Mr. Camdessus noted the need for the Polish authorities to finalize their detailed plans and policy packages for implementation of the second stage of reform, which should be strongly front-loaded and avoid a piece-meal or gradual approach. He stressed that the IMF could play a critical role in the formulation and implementation of such a program. Mr. Whittome visited Poland in late October 1987, and an IMF staff mission is scheduled for mid November 1987 to update information on the reform and implementation plans.

III. MACROECONOMIC PROSPECTS AND EXTERNAL CAPITAL REQUIREMENTS

36. We have found no great difference of view between the Polish authorities and the Bank and the IMF about the source of Poland's economic difficulties and the possible prescriptions to deal with them; where we may differ is on the possible speed of the adjustment process for the external accounts. The proposed rates of growth of national income and total consumption in the Government's current proposals (3.1% and 2.4%, respectively) are not austere and there should be some room to reduce these to attain a more rapid adjustment on the external accounts. Faster external adjustment would facilitate the inflow of fresh capital and technologies, greatly increasing the prospects for a sustained and efficient growth path. Slightly slower growth of national income over the next three years would reduce the rate of increase of required imports. There might also be room to reduce the planned annual growth in investment, and the efficiency of investment should improve over time as real interest rates are increased and as Government improves the application of investment selection criteria.

37. There is also the question of the relative pace of adjustment for the nonconvertible versus the convertible markets for the balance of the 1980s and early 1990s, and the Government's intention to begin to repay CMEA convertible and nonconvertible debt at a faster pace than the debt to western creditors. (Note that Poland has already made a significant adjustment on the convertible account--moving from a large trade deficit to sustained surpluses since 1982--, whereas they have delayed adjustment on the

nonconvertible account, which moved into and remained in deficit during the 1980s.) Direct competition between these two markets might suggest that a faster rate of adjustment could be achieved if exports to CMEA partners were diverted to convertible currency trade. In this respect, however, it is not clear that the nonconvertible trade figures accurately reflect the true economic cost/benefit of such transactions. So far, decisions about intra-CMEA trade are concluded as inter-governmental agreements and usually on the basis of quantities (not value), and there is probably little prospect of changing the planned nonconvertible trade balance for the period 1987-91. For the later period, the rate of adjustment of this account can be considered a policy variable which we intend to pursue with the Polish authorities.

38. We prepared a number of alternative macroeconomic and balance of payments projections which were discussed with the Polish authorities as part of the Green Cover CEM. These were useful to test the range of variables necessary to attain a modestly more rapid adjustment on the external accounts. The macroeconomic and balance of payments figures shown in Annex Tables 1-3 are based on such alternative Bank projections (the "Base Case"), which include the following adjustments to the assumptions included in the Government's revised Scenario: (i) slightly slower GDP growth for the initial years--2.6% versus 3.1% in the Government's current projections; (ii) modest growth in investment (including making major adjustments in efficiency and in the treatment of inventories), at average growth rates of about 1.8% versus the Government's projection of 3% annual growth over the period; (iii) slower per capita consumption growth rates during the initial years; (iv) slightly slower pace of adjustment on the nonconvertible accounts; and (v) slightly higher pace of export growth--slighty over 7% annual growth rates for 1988-90, followed by rates slightly under 7% for the remainder of the period, versus 6.5% in the Government's current projections.

39. External adjustment also requires a counterpart in an improved balance between domestic savings and investment. For purposes of our analysis, we assumed that it would be reflected in a higher level of public sector savings. If private savings do increase, it will probably be to finance, directly or indirectly, an expanded housing program which is critically needed.

40. The Base Case would yield a current account balance in 1990, one year earlier than the Government's Scenario. Total medium- and long-term debt would increase modestly to about $36.4b, and thereafter decline to current levels by 1993, and the debt service ratio would build up to nearly 45% by 1990 and decline modestly thereafter. The Base Case also allows for slightly faster overall and per capita consumption growth by 1992 than the Government's projection, because of the more efficient and significantly lower levels of investment and the slower adjustment on the nonconvertible account.

41. The adjustment process of the Base Case in relation to GDP is summarized in the table below. Over the period 1986-90, the adjustment process is about the same for the nonconvertible and convertible accounts (about 1% of GDP), whereas the Government's projections showed a faster pace for nonconvertible than convertible accounts (1.05% and 0.5%, respectively). After 1990, the Government's projection and the Base Case are similar in concentrating the adjustment mainly on the convertible account, as only a

modest surplus is required to repay CMEA nonconvertible debt. The projected changes imply a total adjustment effort equivalent to about 3.3% of GDP by 1992 in the Bank's alternative projection, compared to the Government's projection of about 2.6% of GDP.

ADJUSTMENT UNDER THE BASE CASE
(as percent of GDP)

	1986	1990	1991	1992	1995
Nonconvertible Current Account Balance [a]	-0.4	0.7	0.7	0.8	1.1
Convertible Current Account Balance	-1.0	0.0	0.6	1.2	2.5
of which: Trade Balance	1.3	3.1	3.3	3.5	4.6
Services and Transfers	-2.3	-3.1	-2.7	-2.3	-2.1
Current Account Balance, Total	-1.4	0.7	1.3	2.0	3.5
Investment-National Savings	1.4	-0.7	-1.3	-2.0	-3.5
Public [b]	7.0	4.9	4.3	3.6	2.1
Private [b]	-5.6	-5.6	-5.6	-5.6	-5.6

a/ The nonconvertible account here includes the bilateral trade which was subtracted from the convertible accounts.
b/ Estimated.

42. On balance, these considerations suggest that a faster pace of adjustment on the convertible currency external accounts is desirable and possible, although not easy. However, the political costs in terms of slower output and consumption growth in the near term will need to be carefully weighed, and the benefits of a faster adjustment clearly identified and understood. The timing and scope of impact from the implementation of the reform measures is more difficult to gauge, and experience in other socialist countries suggests taking a cautious view in expectations for major improvements in the economy's performance in the short- and medium-term.

43. We also prepared a possible financing plan for the Base Case. The basic assumptions included: (i) no changes to restructuring arrangements recently agreed in principle with commercial banks; (ii) full implementation of the recent Paris Club agreement, and treatment of future reschedulings on roughly the same terms, with capitalization of any unpaid interest; (iii) new money from an IMF standby at upper tranche levels and modest amounts of IBRD lending; (iv) progressive buildup of new medium- and long-term lending from commercial sources, plus increased short-term lending to better match Poland's import requirements; and (v) repayment of convertible currency debt to other creditors (including CMEA convertible currency debt) in amounts roughly equal to the repayment to Western creditors over the six year period. The table below summarizes the data in two, three-year periods -- before current account balance (up to 1990) and after (See Annex Table 4 for details by source).

BASE CASE - FINANCING PLAN

(Medium- and Long-Term Convertible Currency Debt)

	1988-90	1991-93
	------(US$ billion)----	
Payments Due: Amortization	10.1	14.2
Interest	10.5	8.4
Total	20.6	22.6
Payments To Be Made: Amortization	3.6	5.1
Interest	7.5	8.4
Total	11.1	13.5
Sources: Poland (out of export earnings)	8.4	10.4
Net New Capital: Banks	0.2	0.8
Paris Club	0.4	2.1
Others	0.7	0.4
IMF	0.8	-0.7
Bank	0.6	0.5
Total	2.7	3.1
Reschedulings: Banks	4.2	1.8
Paris Club (of which interest cap.)	5.3 (2.3)	7.3 (-)
(Total)	9.5	9.1

44. For purposes of our calculations, we assumed rescheduling from the Paris Club on the same terms as the most recent agreement (10 years, including 5 years grace, and interest rates of about 9% on average). If the rescheduling terms for the annual shortfall to be rescheduled were extended from 10 to 15 years, the amount to be rescheduled would be reduced by only about $2.8 billion over the six year period. Therefore, further accommodation via longer rescheduling of principal alone can provide limited relief, while some accommodation on interest rates could be important to ensure that Poland can meet agreed rescheduling conditions, given the high debt service ratios implied by a standard type of rescheduling arrangement.

45. On the basis of the financing plan shown above, the relative shares of exposure shift. The commercial banks benefit relatively more in the first phase (mainly due to the capitalization of interest by the Paris Club). The IBRD share of total medium- and long-term debt remains modest, increasing from zero to about 2% by 1990; in the second phase, the Bank's share would increase to about 4% in 1993, reflecting the expanded lending program described in paras 62-65 below.

BASE CASE - SHARES OF THE FINANCING PLAN

(Medium- and Long-Term Convertible Currency Debt)

	1987	1990	1993
	Percentage		
Paris Club	63 (61)	61 (58)	61 (58)
Banks	23 (26)	22 (26)	22 (27)
Others	14 (13)	12 (12)	12 (11)
IBRD	0 (0)	2 (2)	4 (4)
IMF	0 (0)	3 (2)	1 (1)
	100	100	100
Total MLT Debt ($ billion)	34.7	36.7	35.4

(Figures in parenthesis include short-term lending).

46. An important additional element noted in the table above is the need to increase short-term lending from commercial banks. Poland currently has short term lines of about $1.5 b, less than one third of total imports. Even if this tight ratio were maintained, there would be need to increase short term lending to reflect the growth of imports. With this increase in short term lending from commercial banks, they would increase their relative share of total debt to about 27% by 1993.

47. A difficulty with this type of financing plan is the absence of nonconvertible debt ($4.6 billion equivalent), which the Polish authorities also intend to repay by 1995, by beginning to run surpluses on the nonconvertible trade account. [1] The Base Case assumes that the pace of repayment is about $1 billion equivalent slower than the Government's projections, and is reflected in the adjustment/GDP discussion in para 41 above. The possibility of Poland being able to restructure its financing agreements with CMEA and other creditors along these lines is not clear. Fuller discussion of these matters with Western creditors is in order when putting together any financing plan.

IV. BANK STRATEGY OF ASSISTANCE

48. Our overall strategy is to support the long-term objectives of the Polish authorities--namely to improve efficiency and productivity of the economy, to enable growth and improved socioeconomic conditions, as well as the market-oriented policies the Government intends to adopt to achieve them. We have formulated a strategy for Bank work which assists the Government in addressing the basic issues outlined in para 23 above, namely the reform of the economic system, restructuring its productive base, and obtaining external support. We consider that the most critical and urgent need now is to embark on a credible path to restore creditworthiness.

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[1] Note that the convertible CMEA debt (which amounts to about $2.6 billion in 1987) is included in the convertible currency financing plan described in para 43 above.

49. The Polish authorities share our view of the critical importance of regularizing Poland's external financial relations, so that it can have a reasonable footing to implement fully the reforms and resume sustainable growth. The recovery made so far by the Polish economy was accomplished without additional external flows. However, this came about through the rolling over of a huge debt burden under precarious conditions, accumulation of large interest arrears, and a large compression of imports which severely affected and will increasingly undermine Poland's competitive edge in the productive sectors. With the resumption of more normal trade and credit relations, Poland could take better advantage of technological and efficiency advances and accelerate its growth. Simply to be rid of the necessity to continually deal with the debt on a crisis basis would also permit development of more conducive commercial relations. It should also be noted that this is not purely an economic calculation, but also represents the Polish intention to sustain and enhance its relations with the West for political, cultural and national reasons.

A Possible Program for the Near Term

50. During the February 1987 visit to the Bank by Professor Baka, President of the Central Bank and Poland's Governor for the World Bank, the Polish authorities proposed the following approach for breaking out of the current difficult set of external economic relations We consider it a feasible, though fragile strategy for the next two to three years, and note that the first important steps have already been taken and are beginning to elicit a positive response from Poland's current creditors. While the outline presented below appears as a sequence of discrete steps, their likely evolution will be less clearcut, with the inter-actions of the various actors (Poland, Bank, IMF, other creditors and trade partners) having an effect on each other. Once the process starts moving and gains momentum, the steps may be accelerated and/or merged.

(a) The Polish authorities prepared a credible, time-bound, medium-term program for macroeconomic and debt management as well as key features for the implementation of the reform; are utilizing IMF and Bank technical assistance for the finalization of that plan; and have started implementing some parts of the plan already.

(b) The program's annual targets would be agreed with and monitored by both the IMF and the Bank. They have been submitted in general terms to the Paris Club and the commercial banks, to make them aware of what Poland is willing and committed to do and what type of support is needed; Poland is now seeking agreements in principle on the acceptability of its plans and support under specified conditions.

(c) On the basis of this program and with the firm prospect that other creditors and institutions will also provide appropriate support over time, the Bank would start lending to Poland in FY88 at a modest level.

(d) The Polish authorities would continue working with the IMF and the Bank to monitor their program and progress, building up to formal negotiations for an IMF standby in 1988, which would be complemented by further multi-year reschedulings of official debt and possibly new external flows.

51. It is evident that there are many risks associated with this strategy. First, there is the risk of adverse internal political reaction to the implementation of the reform and the trade-off between consumption growth and debt service. While the Government has started implementing such policies (e.g., devaluation of the zloty, price increases), there is a considerable risk, judging from history, that it will face considerable resistance. The Polish authorities are keenly aware of such risk, but believe it must be taken. Their plans have been openly prepared, are being publicly debated, and include some substantial up-front measures which will provide an early test of their acceptability. Second, the design of such a major reform and restructuring effort is a daunting task, and one for which there are few precedents to help guide them. The Government is therefore trying to create the economic and institutional conditions necessary to make possible the other intended improvements. These include a drastic reduction in the role of central administration, liquidating barriers to economic incentives and opening up to external stimuli, in the hope that these new dynamics would sustain and accelerate the reform and restructuring processes.

52. A third major risk is that at the export-led approach may encounter more difficulties than foreseen, both internally and externally. Judged on the basis of production potential, we consider the projected 6.9% overall annual average growth rate for convertible currency exports to be feasible, but far from easy. Export prospects are greatly affected by projections for coal, which has provided about 20% of export earnings from convertible markets. Coal mining productivity in Poland is already high and geological conditions make it very difficult to increase output. Therefore, vigorous pursuit of the ongoing energy conservation program and the carrying out of proposals to increase the domestic price of coal will be crucial. The 11% growth rate of the engineering exports is also ambitious, but should be attainable if bottlenecks can be removed by importing critical inputs and profitable exports are not constrained by central allocation. The improved export performance of light industry and wood products and the modest growth for construction services both seem feasible. Concerning markets, we are reassured by the fact that the Poland is not a major supplier in most markets and in fact it will take a significant increase in exports to regain market shares lost in the early 1980s.

53. Another major risk is that their program will not elicit the type of international support on which the Polish authorities are counting, and therefore they will not be able to arrange sufficient external financing to "fuel" the process. While the Polish program is not predicated on a very large flow of net additional resources into Poland, the need for rescheduling is large and the symbolic presence of IBRD and IMF lending is important. The response so far from current creditors is encouraging. The Polish authorities hope that its current creditors understand that it is in the best interest of all that Poland is able to improve the efficiency of its economy and expand trade, and therefore increase its capacity to service its debt. Without this support, it would be difficult for the Polish leaders to defend maintaining the planned high debt service ratios, and thereby weaken political support for keeping debt service as a high priority of the program.

54. There is also the risk that, given the rather short time frame allowed by the latest Paris Club agreement and the necessity for a continuing sequence of reschedulings, the Paris Club may stiffen its demands once Polish export capacities begin to increase. However, the Polish authorities should

be able to resist this form of excessive "taxation" of exports by fully developing their debt repayment plans and assumptions, making clear to all creditors the range of debt service payments Poland is prepared to make. Finally, there is the risk that, while the external political environment seems at present increasingly supportive (both East and West), circumstances may change.

55. Despite these risks, a great deal of progress has been made, especially in the past six months. The dynamics of these processes are growing stronger, cumulative, and moving in the right direction. If the international financial institutions do not take the risk of assisting Poland to develop and implement a sound medium-term program, they would probably miss an historic opportunity, with a strong probability of Poland continuing to be unable to meet its obligations and slowing down, if not abandoning, its market-oriented reform, an alternative neither the Polish authorities nor we consider desirable as it would have evident adverse economic and political consequences.

Role for the Bank in FY88

56. We propose to support the Polish authorities in the implementation of this approach to restore creditworthiness and resume sustainable growth. Our first priority is to continue our dialogue and assistance already started through the first economic report and the CEM to facilitate further strengthening, detailed preparation and implementation of the Government's program along the lines of the Base Case. We would continue to work closely with the IMF on these issues and the evolution of the Polish position and that of the other creditors. So far the authorities have shown great receptivity to our advice and asked that we continue and intensify it. However, for the recovery path and the reform program to have any chance of success, they must be (and be clearly seen to be) Polish proposals and not dictated by outside forces.

57. On the basis of what has been provided already (see paras 13-19 above), we would be willing to initiate a lending program to contribute to the financing of the recovery program. We would monitor developments and progress in implementing the Government's plans, establishing an active relationship with the IMF, and regularizing relations with the Paris Club, before inviting formal negotiations, to ensure that the overall program is working well and the financing plan underlying the Government's program is viable. Work is well underway on several high priority projects which could be ready for Board presentation by the end of FY88, assuming all goes well in establishing and implementing the recovery approach outlined above. We also recommend making a PPF in the second quarter FY88 to facilitate the preparation of potential projects.

58. We propose to initiate our lending program in FY88 with 1-2 projects for $250-300 million, for activities which would increase the convertible currency trade surplus (See Annex Table 5). Lending at these levels represents about one third of that for which Poland could theoretically be eligible, given the size of its economy (1986 GDP $74 billion, 37 million people). We suggest taking this modest approach, keeping in mind the need to make a significant contribution to assist the Polish authorities to undertake the necessary measures to restore overall creditworthiness, while at the same time recognize the risks inherent in their approach.

59. Project selection would focus on those foreign exchange expenditures which can be shown to have a direct and immediate effect on the export capacities, such as debottlenecking investments, working capital to finance imported inputs, raw material, spares, etc. Special care is being taken in the definition of the first projects to ensure that those selected stay well within the parameters of what is likely to be the long-run structure of each subsector. Through this bottom-up approach, we also expect to monitor and support the implementation of the reform, because policy measures and administrative reforms have significance only through their impact on actual economic and financial decision-making at the enterprise level, where in turn understanding of and support for the reform are essential for the success of the reform itself.

60. Our economic and sector work program for FY88 builds on that initiated in FY87 (See Annex Table 6). Economic work in FY87 included a first informal economic report and the CEM; we also initiated work on a Domestic Resource Cost (DRC) study. Sector work in FY87 focused on agricultural trade strategy issues, energy management/investment selection, transport constraints to exports, and financial intermediaries. Economic work in FY88 includes another CEM, focussing on export and financial sector issues, and the continuation of the DRC work. Sector work includes the completion of the energy, transport and financial intermediaries studies initiated in FY87, as well as an agriculture survey and industrial subsectoral restructuring studies. The FY87 work program (including lending) amounted to about 11 staffyears, and that for FY88 amounts to about 18 staffyears.

61. Other Output will be an important part of our program of assistance. As with all new member countries, there is a significant "education" program necessary to introduce the member to the Bank's practices and procedures. We have also begun a series of special seminars for Polish officials on procurement and project cycle issues, and EDI is assisting us to arrange the first industrial project appraisal course this fall.

Role for the Bank Beyond FY88

62. Assuming continued satisfactory progress on the implementation of the agreed overall program of reform and an IMF standby in place, we would seek to increase the Bank assistance program and gear our lending more directly towards the restructuring needs of the economy, sustaining the progress of the reform program. To this aim, we are prepared to undertake a larger and more ambitious lending program, including a number of hybrid operations (blend of policy and investment lending) along the lines of the ongoing Hungary program. The go-ahead for proceeding with such operations would be reconfirmed annually on the basis of a review by Regional management of the steps actually taken to implement the Government's agreed program. The status of these measures and progress in the further development and implementation of the Government's programs would be presented for Senior Management review in an annual Country Strategy Paper update.

63. The Government would update the Medium-Term Scenario presented to us in July 1987, reconfirming its overall program and establishing an agreed implementation schedule in a form similar to a development policy letter. We would expect such a program document to present a rolling three year program, with a monitorable timetable of key actions. Therefore, we would not seek

additional conditionality within each hybrid project related to the macroeconomic situation or the reform. The conditionality in such projects would be related to sector or project issues. Our economic and sector work program would be directed to help develop and expand the reform and restructuring programs, and the scale and timing of the lending program would be based on the progress actually attained. These hybrid projects, as well as the standard projects, would make interesting vehicles for possible cofinancing.

64. We believe that the Polish economy must undergo major systemic and policy reforms, and therefore are prepared to move toward a lending program with significant policy-based lending instruments, perhaps as soon as FY89. This sort of program would need to be carefully developed, as we see how the Polish authorities implement the reform and recovery plans and as our own expertise in the Polish system and economy increases. Given the importance of foreign trade issues and the relatively advanced state of preparation of many of the Government's proposed programs related to foreign trade, a likely high priority candidate is a Trade Adjustment Loan. Other possibilities include financial sector reform or a SAL.

65. While the Polish authorities are naturally interested in the prospect of large new flows of funding and would like a large Bank lending program as soon as possible, they understand that the Bank cannot provide funds essentially to allow Poland to repay its bilateral and commercial creditors, nor are we in a position to finance a major share of their overall needs (now or even in the distant future). They appreciate the fact that the major impact of Bank lending will come not from the funding but rather by the policy advice and technical assistance and by the demonstration of public support for their recovery plans. Assuming the implementation of the Governments plans merits moving on to hybrid and possibly policy-based lending over time, we foresee it possible, given the size of the economy, to build-up to an annual lending program well in excess of the $250-300 million proposed for FY88, up to about $800 million per year.

66. Poland is completing arrangements to join IDA and IFC. IFC has already fielded a number of missions to review investment opportunities, and the Polish authorities are keenly interested to benefit from IFC's participation in the implementation of Poland's new joint venture law. Discussions are also underway concerning MIGA.

Attachments : Postscript to Poland - Country Strategy Paper, Meeting held on September 22, 1987 in Conference Room E-1208

Table 1 Base Case - Key Economic Indicators
Table 2 Base Case - Balance of Payments
Table 3 Base Case - Economic Indicators
Table 4 Base Case - Financing Plan
Table 5 Proposed Lending Program
Table 6 Proposed Economic and Sector Work Program

Annex I History of Poland's Convertible Currency Debt
Annex II Description of Major Sectors

BASE CASE

Key Economic Indicators

	1985 Actual	1986 Estimate	1987 Projected	1988	1989	1990	1991	1992	1993	1994	1995
GDP Growth Rate (%)	3.6	5.1	3.1	2.6	2.6	2.6	3.3	3.3	3.3	3.5	3.5
Consumpt Per Capita Growth (%)	5.6	5.0	2.3	1.4	2.0	1.5	2.4	3.5	3.0	2.7	3.4
DODMLT (Mln US$)	28300.0	33937.4	34674.1	35737.7	36433.0	36425.1	36017.3	35506.5	34758.2	33718.6	32353.9
DOD/XGS (%)	465.0	557.5	500.8	473.8	430.7	408.1	376.5	336.5	305.6	274.3	244.5
DOD/GDP (%)	39.9	45.1	53.4	58.4	54.6	55.1	53.1	50.6	49.2	47.0	45.8
Debt Service (Convertible Currency) Due:											
Debt Service			4216.4	4725.4	4907.8	5851.4	6553.5	7261.0	7535.7	7939.0	8357.7
Debt Service/XGS (%)			60.9	62.7	58.0	65.6	68.5	68.8	66.2	64.6	63.1
Debt Service/GDP (%)			6.5	7.7	7.3	8.9	9.7	10.3	10.7	11.1	11.8
Debt Service (Convertible Currency) Paid:											
Debt Service	2584.0	1713.6	2317.6	2852.8	3369.0	3968.1	3897.1	4136.4	4568.4	4907.4	5154.8
Debt Service/XGS (%)	42.5	28.2	33.5	37.8	39.8	44.5	40.7	39.2	40.2	39.9	38.9
Debt Service/GDP (%)	3.6	2.3	3.6	4.7	5.0	6.0	5.7	5.9	6.5	6.8	7.3
Interest (Convertible Currency) Due:											
Interest/XGS (%)			44.1	46.0	40.5	36.3	30.8	27.5	25.2	22.9	20.7
Interest/GDP (%)			4.7	5.7	5.1	4.9	4.3	4.1	4.1	3.9	3.9
Interest (Convertible Currency) Paid:											
Interest/XGS (%)			21.9	26.8	29.3	36.3	30.8	27.5	25.2	22.9	20.7
Interest/GDP (%)			2.3	3.3	3.7	4.9	4.3	4.1	4.1	3.9	3.9
Gross Investment/GDP (%)		28.9	28.9	28.6	27.9	27.7	27.6	26.9	26.4	26.2	25.6
GDS/GDP (%)	28.8	30.2	30.2	30.5	30.3	30.5	30.6	29.9	29.6	29.6	29.0
Marginal Savings Rate - 3 Year			0.36	0.26	0.28	0.35	0.31	0.25	0.23	0.22	0.23
ICOR	6.6	7.1	7.1	8.4	8.5	8.5	6.8	6.8	6.7	6.4	6.4
Growth Rate (%):											
Export Goods, CC	-2.2	-2.6	3.9	7.0	7.1	7.2	6.8	6.9	6.9	6.8	6.9
Imports Goods, CC	1.8	0.3	5.2	3.8	3.8	3.8	6.6	6.6	6.6	6.1	6.3
Convertible Currency:											
Cur Account (Mln US$)	-355.4	-660.5	-536.7	-813.6	-395.3	7.9	407.8	860.7	1098.4	1439.6	1764.7
Cur Account/GDP (%)	-0.5	-0.9	-0.8	-1.3	-0.6	0.0	0.6	1.2	1.6	2.0	2.5

Table 1

: CASE

POLAND
BALANCE OF PAYMENTS

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
	Actual		Estimate	Projected								
Convertible Currency (Mln US$)												
Current Balance	-1172.4	-355.4	-660.5	-536.7	-813.6	-395.3	7.9	407.8	860.7	1098.4	1439.6	1764.7
Trade Balance	1363.6	1168.2	1039.6	1084.1	1385.1	1744.5	2057.4	2235.7	2436.0	2660.8	2931.4	3218.4
Exports	5471.0	5348.1	5314.6	5846.0	6605.9	7457.6	7971.3	8623.4	9335.6	10113.5	10942.7	11848.4
Imports	4107.4	4179.9	4275.0	4761.9	5220.8	5713.1	5913.8	6387.7	6899.6	7452.7	8011.4	8630.0
Services Balance	-2998.0	-2287.6	-2644.1	-2620.9	-3198.7	-3139.8	-3049.5	-2827.9	-2575.3	-2562.5	-2491.8	-2453.7
Receipts	717.0	737.4	772.9	1077.1	936.3	1002.3	953.3	943.5	1216.4	1261.3	1347.9	1386.8
of which: Interest	0.0	91.5	170.0	150.0	150.0	200.0	200.0	200.0	250.0	250.0	250.0	250.0
Payments	-3715.0	-3025.0	-3417.0	-3698.0	-4135.0	-4142.1	-4002.8	-3771.4	-3791.7	-3823.8	-3839.7	-3840.5
of which: Interest 1/	-3112.0	-2438.0	-2734.0	-3054.4	-3467.4	-3428.4	-3240.1	-2949.3	-2905.6	-2870.1	-2817.8	-2740.2
Priv Transfers (Net)	462.0	764.0	944.0	1000.0	1000.0	1000.0	1000.0	1000.0	1000.0	1000.0	1000.0	1000.0
M & LT Obligations	-3113.0	-3784.0	-1552.0	-1162.0	-1258.0	-1479.4	-2611.3	-3604.3	-4355.4	-4665.6	-5121.3	-5617.6
Credit Extended,net	-208.6	4.4	-253.0	-200.0	-150.0	-200.0	0.0	0.0	-250.0	-250.0	-300.0	-300.0
Balance to be Finance	4494.0	4135.0	2465.5	1898.7	2221.6	2074.7	2603.4	3196.4	3744.6	3817.2	3981.7	4152.9
External Debt	26850.0	28300.0	33937.4	34674.1	35737.7	36433.0	36425.1	36017.3	35506.5	34758.2	33718.6	32353.9

1/ Includes interest payments to be capitalized and thereafter included in rescheduling agreements for period 1987-89.

Table 2

Table 3

POLAND - ECONOMIC INDICATORS

Population: 37.4 Mln (Mid-1986)

	1986 (Mln US$) (Current)	1984	1985	1986	1987	1988-92	1995
		Annual Growth Rate (%)					
		Actual			Projected		
F Trade (Convertible Currency)							
Mer..andise Exports	5316.0	9.0	-2.2	-2.6	3.9	6.9	6.9
Fuel	1090.0	14.1	-25.5	-2.6	-5.0	0.0	0.0
Engineering Products	1300.0	-4.2	1.4	-2.6	6.0	8.1	10.0
Others	2926.0	8.6	8.0	-2.6	6.2	8.1	7.0
Merchandise Imports	4507.9	7.4	1.8	0.3	5.2	5.0	6.3
Intermediate Goods	2837.1	11.1	-1.6	-1.4	5.9	5.0	6.6
Capital Goods	510.7	15.2	25.5	1.1	4.7	5.0	6.6
Others	1160.1	-4.5	2.6	2.7	4.2	5.0	5.9
Prices							
Export Price Index			100.0	102.0	108.0	119.7	127.9
Import Price Index			100.0	102.0	108.0	119.7	127.9
Terms of Trade			100.0	100.0	100.0	100.0	100.0

	1984	1985	1986	1987	1988	1990	1995
	Composition of Trade (% at current prices)						
Merchandise Exports	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Fuel	26.6	20.3	20.3	18.5	17.4	14.2	10.9
Engineering Products	19.8	20.5	20.5	21.0	21.3	22.1	23.9
Others	53.6	59.2	59.2	60.5	61.4	63.7	65.2
Merchandise Imports	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Intermediate Goods	58.5	56.6	55.7	56.0	56.0	56.0	56.0
Capital Goods	7.0	8.6	8.7	8.6	8.6	8.6	8.6
Others	34.5	34.8	35.6	35.3	35.3	35.3	35.3

	1985 Current Zl Bln	1985	1986	1987	1988	1989-95	1995
		Real Growth Rates (%)					
		Actual	Estimate		Projected		
Gr.. Domestic Product	10445.0	3.6	4.9	3.1	2.6	3.2	3.5
..try	4465.2	4.0	4.4	3.1	2.7	3.5	3.8
..lture	1416.2	0.2	5.0	3.1	2.3	2.7	2.9
..ers	4563.6	4.3	5.5	3.1	2.7	3.1	3.3
Consumption	7399.2	3.2	2.9	3.1	2.2	3.6	4.2
Gross Investment 1/	2888.2	6.2	8.8	3.1	1.6	1.8	0.8
Total Exports of GNFS	1900.6	0.3	6.8	2.3	6.7	5.3	5.3
Total Imports of GNFS	1752.7	6.9	4.3	2.4	3.2	4.6	4.8
Unallocated Items	9.7						
Gross Domestic Savings	3045.8			3.0	3.6	2.5	1.6

1/ Includes stocks.

	1984	1985	1986	1987	1988	1989-95	1995
	Actual		Estimate		Projected		
Gross Domestic Product	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Industry	38.6	40.0	42.0	43.9	43.9	44.2	44.6
Agriculture	16.4	16.2	16.2	15.8	15.8	15.5	15.3
Others	45.0	43.8	41.8	40.3	40.3	40.3	40.1
Consumption	72.6	71.2	69.8	69.8	69.5	70.1	71.0
Gross Investment 1/	26.3	27.9	28.9	28.9	28.6	26.8	25.6
Total Exports of GNFS	16.7	16.6	16.9	16.8	17.4	19.3	20.3
Total Imports of GNFS	15.5	15.6	15.6	15.4	15.5	16.2	16.9
Unallocated Items	-0.9	0.1	-0.6				
Gross Domestic Savings	27.5	28.8	30.2	30.2	30.5	27.7	29.0

1/ Includes stocks.

Other Indicators

Prices	1984	1985	1986	1987	1988	1989-95	1995
	Actual		Estimate		Projected		
... Change)	22.1	15.0	17.7	6.1	35.7	7.3	6.1
...lator (% Change)	-14.7	23.5	-3.2	17.0	35.0	6.0	6.0
Excnange Rate (Zl/US$)	113.72	147.18	200	250	375	560	750
GDP per Capita (% Change)	4.5	2.8	4.1	2.3	1.8	2.4	2.6
GNY growth rate (%)				3.4	2.0	3.5	3.6
GNY per capita (% Change)				2.5	1.2	2.7	2.8
ICOR	3.8	6.6	7.1	7.1	8.4	7.2	6.4

Bas

POLAND

Alternative Scenario - Financing Plan

Convertible Currency Debt

Years	Banks 1988-90	Banks 1991-93	Paris Club 1988-90	Paris Club 1991-93	Others 1988-90	Others 1991-93	IMF 1988-90	IMF 1991-93	IBRD 1988-90	IBRD 1991-93	TOTAL 1988-90	TOTAL 1991-93
Total Due	7.2	4.8	10.9	14.8	2.3	1.9	0.1	0.7	0.1	0.4	20.6	22.6
Amortization	4.7	2.9	4.4	9.6	1.0	1.1	0.0	0.5	0.0	0.1	10.1	14.2
Interest	2.1	1.9	6.5	5.2	1.3	0.8	0.1	0.2	0.1	0.3	10.5	8.4
Poland pays out of export earnings Total											8.4	10.4
Financed by Net capital												
Inflows: Gross	0.2	1.3	0.5	2.4	0.8	0.9	0.9	0.0	0.7	0.9		
Amortization paid on new capital	0.0	0.2	0.0	0.0	0.0	0.2	0.0	0.5	0.0	0.1		
Interest paid on new capital	0.0	0.3	0.1	0.3	0.1	0.3	0.1	0.2	0.1	0.3		
Net	0.2	0.8	0.4	2.1	0.7	0.4	0.8	-0.7	0.6	0.5	2.7	3.1
Total Debt Service Paid	3.0	3.0	5.6	7.5	2.3	1.9	0.1	0.7	0.1	0.4	11.1	13.5
Amortization	0.5	1.1	2.1	2.3	1.0	1.1	1.1	0.5	0.0	0.1	3.6	5.1
Interest	2.5	1.9	3.5	5.2	1.3	0.8	0.1	0.2	0.1	0.3	7.5	8.4
Rescheduled	4.2	1.8	5.3	7.3							9.5	9.1
Amortization	4.2	1.8	2.3	7.3	0.0	0.0	0.0	0.0	0.0	0.0	6.5	9.1
Capitalized Interest	0.0	0.0	3.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	3.0	0.0

Note: This table shows modest new capital inflows from the Paris Club. Discussions with the Japanese and other countries indicate that higher new capital inflows may be forthcoming. To the extent that these materialize, with similars as we are assuming for reschedulings, they will simply reduce correspondingly the rescheduling requirements.

EM4CO
November 6, 1987
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Table 4

Table 5

Poland - 5 Year Lending Program
(US$ million)

FY88		FY89		FY90		FY91		FY92	
Industrial Exp.	250	(S) Agro Process	50	(S) Ind. Restr. I	300	(S) Agric	100	Ind. Policy	300
		Energy I	250	(S) Transport	100	Telecoms	60	(S) Energy Policy	250
						Financial Sector	150	Transport Policy	250
						Ind. Restr. II	250		
(1)	250	(2)	300	(2)	400	(3)	560	(3)	800
STANDBYS									
Agro Process	50	Ind. Restr. I	250	Agriculture	100	Energy Policy	250	Ind. Restr. III	250
		Transport	100						
RESERVES									
		Energy II	200	Trade Adj.	250	SAL I	250	SAL II	250

November 6, 1987
2413G

POLAND

Economic and Sector Work Program

		Staffweeks	
		FY88	FY89
ERA	CEM #2	50	40
	DRC Study	41	
	Investment Review		70
EWO	Debt Study	20	
	Macro Management Scenarios	5	
	Stages of Reform	5	
	Other		20
SRA	Energy Investment Study	40	
	Fin. Intermediaries	4	
	Transport Constraints	20	
	Industrial Policy	35	60
	Subsectoral Studies	23	45
	Agriculture Trade Strategy	5	
	Crops and Investment	50	30
	Livestock	40	20
	Unidentfied SRA		30
		318	315

2413G
August 25, 1987

HISTORY OF POLAND'S CONVERTIBLE CURRENCY DEBT

Relations 1971-1980

1. During the 1970s, the Government of Poland pursued a new "intensive development" strategy which called for a major increase in imports of western capital and consumer goods. To finance these imports, and while awaiting the anticipated increase in domestic production and exports, the Government arranged substantial convertible currency (cc) borrowings. This major shift in development strategy towards increasing international trade and the accompanying inflow of cc lending was facilitated by factors exogenous to Poland. The period of the 1970s Witnessed a thaw in East/West relations, opening more and friendlier official contacts, thereby easing prospects for expanded trade as well. While many western businesses and creditors were pleased at the prospect of developing expanded relations with individual Eastern European countries, they also operated under the widely-held assumption that the Soviet Union was sanctioning the Polish endeavors and would step in, if needed, to ensure that no member of its bloc failed to meet its external obligations--the so-called umbrella theory. The general improvement in East/West relations was also accompanied by western government's appraisal that the new Gierek regime in Poland represented a major improvement over that of Gomulka, which was toppled in 1970 by popular unrest after economic stagnation.

2. As to trade and financial conditions, Western governments and businesses were anxious to benefit from increased export prospects to Poland, a large and potentially lucrative market which had been essentially closed off during the Gomulka years. Imports from the cc area increased five fold during this period. Some of the associated lending was contracted by Polish foreign trade organizations, but most was incurred directly by the official foreign trade bank--Bank Handlowy. The funds were provided largely from eurodollars being accumulated in western banks. As a result, despite the fact that US banks provided only about 10-15% of Poland's cc medium- and long-term borrowings, about 50% of total medium- and long-term debt is dollar denominated. Most commercial bank lending was arranged bilaterally, with a few syndicated loans mainly in the mid-1970s.

3. During 1971-80, the total value of medium- and long-term cc credits received by Poland amounted to nearly $39 billion equivalent (gross). The pace of lending accelerated with the accumulating negative trade balances, resulting in 80% of total gross debt being incurred in the last five years of the period. Short-term lending was maintained at fairly modest levels (only about $2.9 billion by 1980) because the Government was able to borrow medium-term for large parts of its consumption needs (e.g., US Commodity Credit Corporation and Canadian Wheat Board for cereals imports). Poland also incurred cc debt to CMEA members of about $2 billion equivalent and nonconvertible debt of about $1.5 billion equivalent up to 1980.

4. The major source for this rapid expansion of cc debt was official export credit (and/or guarantees), and not bilateral full-risk lending from commercial banks. Some in the banking community ascribe this shift to their early reading of potential debt service difficulties and prudent search for risk-cover, whereas others contend that western governments sought to use trade relations to influence Polish domestic politics as it was evolving in the late 1970s and therefore had to "pay the bill." Also contributing to this higher political profile (at least in West Germany) was the settlement of the Polish/German border question, at issue since the end of WW II. (Incidentally, two West German banks rank second and third in terms of largest holdings of Polish debt; first position is held by Banque Nationale de Paris.) This was also a period of fierce competition in international capital goods markets, a competition in which most governments sought to assist their own exporters.

5. While the banks preferred to think of their lending as supporting discrete investment projects (and the Polish authorities tried to push this idea as well), most acknowledge that they knew they were providing balance of payments support. Furthermore, they were aware that by the late 1970s, the investments were not providing the anticipated returns and exports, and Poland was borrowing to pay interest. Interest payments grew five fold over the 1974-80 period, due to the build-up of debt and increasing interest rates. In 1980, Poland's debt service paid was equivalent to about 96% of exports of goods and nonfactor services, including a massive repayment of over $5.6 billion principal during that one year.

Crisis of 1981

6. On March 26, 1981, the Polish Government informed its creditors that it would not be able to meet its agreed payments. The official and commercial creditors took different paths to deal with this situation. The official creditors (15 countries, later 17 including Brazil) worked through the Paris Club and quickly agreed on April 17, 1981 to reschedule 90% of principal and interest payments due during the last three quarters of 1981 (about $2 billion), for eight years, including four years grace. While they were also prepared to look at the need to reschedule payments due in 1982, they informed the Polish authorities that they would not begin such discussions until the Poles had completed agreements with the commercial banks for their respective 1981 payments. The largest official creditors are: West Germany 24%, Austria 15%, USA 12%, France 12%, and Brazil 11%.

7. It took longer for the commercial creditors to pull together their own position, as they decided to form a special consortium to deal with this, the first major debt rescheduling of the 1980s. The only major commercial lenders that did not join the group were the Middle Eastern banks, which currently hold about $700 million equivalent of Polish debt. The banks also invited Poland's CMEA creditors (which held cc debt) to join the exercise, but were rebuffed. The umbrella theory was tested and found to be invalid.

8. The commercial bank rescheduling process is managed by a steering committee, representing the major national lending groups. The leadership rotates, and is currently chaired by Creditanstalt Bankverein - Austria. Their procedures require that once an agreement in principle is reached and initialled by the steering committee, there must then be a formal signing of the agreement on behalf of each creditor, followed by signing of revised loan documents with each creditor. Unlike arrangements made subsequently for debt reschedulings with other countries, the original operating procedures for the Poland group were established (and remain) to require 100% of all creditors to agree to the rescheduling terms.

9. The banks reached agreement with the Polish authorities in late 1981 to reschedule 95% of principal due that year (about $2 billion equivalent); however, unlike the Paris Club, they insisted on full payment of interest due. The rate of interest was set at a spread over LIBOR, plus a rescheduling fee. Short-term lending was explicitly excluded from the rescheduling, but nonetheless, the commercial banks cut their short-term exposure by more than half during 1981.

10. On December 13, 1981, the Polish Government declared Martial Law. The reaction of most of the Paris Club members was very negative, but it was not at a Paris Club meeting, but rather at a NATO conference on January 11, 1982 that the official western creditors announced that they would not consider future rescheduling with Poland until the domestic situation improved. The US imposed sanctions against Poland, including suspending airline landing rights and fishing rights, withdrew most-favored-nation trading privileges, and cut-off export credit guarantees. Other official Western creditors took less stringent measures, but all suspended further export credit guarantees. During the 1982-83 period of Martial Law, there were no official contacts with the Paris Club and the Polish Government paid neither interest nor principal to its official creditors.

The Aftermath

11. Unlike the official creditors, the commercial banks continued to meet with the Polish authorities. The banks set up a special economic subcommittee to gather economic and financial information, to enable them to follow developments and act accordingly, in the absence of an IMF presence in Poland. They also arranged for Peat Marwick Mitchell and Co. to assist Bank Handlowy in consolidating its debt information for purposes of the debt rescheduling negotiations.

13. With the first rescheduling, auditors and regulatory authorities for most of the commercial banks started to require provisions against Polish debt. US regulators now require provisions for a minimum of 45% of medium- and long-term Polish debt; West German tax authorities allow 50% of total Polish exposure to be written off. It is generally understood that nearly all banks have written off at least 50% of their Polish debt, and are aggressively reducing these balances as fast as their profits allow. Poland's debt currently sells for a discount of over 50%.

14. Facing this requirement for provisions, and with no real incentive to increase their exposure, there has been no new commercial unguaranteed commercial lending to Poland since 1981. Nonetheless, the commercial banks did open a revolving trade facility for Poland, which provided cash cover for letters of credit opened by Bank Handlowy with correspondent banks, for 180 days at interest rates comparable to those for the rescheduled debt. This facility must be regularly paid off and reopened (not rolled-over). Imports financed via the trade facility are supposed to be those which support Poland's export capacity. The trade facility currently amounts to about $800 million (less than 20% of imports). After some initial start-up difficulties, Poland has maintained an impeccable repayment record on the trade facility in addition to paying cash for 80% of its annual imports.

15. Since 1981, the banks have arranged four rescheduling agreements with the Polish authorities, shifting from single to multi-year agreements. The basic ingredients of previous reschedulings are full payment of interest, rescheduling of 90-95% of principal over longer and longer periods with the spread over LIBOR from $1^{3/8}$ being gradually reduced with each subsequent rescheduling. A new development is an agreement in principal with the steering committee (early August 1987) which covers nearly all commercial debt (about $7-8 billion due over the next six years) rescheduling it over 15 years and lowering the spread over LIBOR to 15/16. We understand that the terms include two stages, with the second being put into force after Poland has negotiated an arrangement with the IMF of upper tranch conditionality for at least six months; moreover, this second stage starts only in 1991, providing a relatively long lead-time to complete such arrangements.

16. After the lifting of Martial Law, the Paris Club reopened discussions with the Polish authorities in October 1983. Unlike the first official rescheduling in 1981, these took a long time and involved very difficult negotiations. By July 1985, the Paris Club reached agreement to reschedule 100% of principal and interest due during the 1982-84 period (about $10.8 billion equivalent) for ten years, with five years grace. One of the major stumbling blocks to agreement was the treatment of interest incurred during the break in relations. Subsequent agreements for 1985 have been on roughly the same terms, arrived at after the fact of nonpayment and accumulation of arrears.

17. Official debt has tended to increase, partly because more of the Polish debt originally classified as full-risk turned out to have an official guarantee, and in part because of the capitalization by official creditors of accumulated interest arrears and interest on late interest. Currently, official creditors hold about two thirds of Polands cc debt of about $33 billion (including capitalized interest), making Poland the largest creditor to the Paris Club. (On the otherhand, Poland currently owes the CMEA only about $4.6 billion equivalent.)

18. After several unsuccessful attempts to come to agreement with the Paris Club since the last rescheduling covering 1985 payments, they initialled an agreement in late October 1987 covering all interest arrears through March 1987, moratorium interest during 1987, and all debt coming due through December 1988 (about US$9-10 billion, or equivalent to about 40% of Poland's official debt). The terms are for 10 years, including 5 years of grace. While this rescheduling is not the major multi-year rescheduling which some parties in Poland had hoped for, it is the first time the Paris Club has agreed to more than a few months lead time. The rescheduling agreement does not include any preconditions to be met before it can be put into effect related to the IMF and its conditionality, and makes no reference to possible future reschedulings. All sides seemed content to allow this negotiation to cover an interim period during which would occur many developments affecting prospects and conditions for potential future agreements.

BACKGROUND ON MAJOR SECTORS

Industrial Sector

1. The industrial sector (comprising--according to the Polish definition--mining, energy, as well as manufacturing) has been the leading sector of the national economy since 1960. Currently it contributes about 50% of net material product and employs 29% of the country's labor force. The socialized industrial enterprises (i.e., state-owned enterprises and cooperatives) produce almost 95% of industrial production and employ over 90% of the industrial work force. Industrial exports have maintained a predominant share in total exports (90% in 1986), of which about 46% were directed to convertible currency markets.

2. Polish industry is characterized by a high degree of concentration and little competition. Socialized enterprises employing over 1,000 workers account for about 66% of industrial employment and output. Private industrial activities, mostly artisanal and household operations, account for about 5% of industrial net production and employ about 450,000 persons.

3. Energy. Poland is the fourth largest coal producer in the world and fourth largest coal exporter. About 18% of hard coal production is exported, amounting to about 20% of total Polish exports. Poland also has lignite and oil and gas reserves. For domestic energy use, coal accounts for about 80% of all primary energy consumption, making Poland one of the most coal-dependent countries in the world. Much of Poland's environmental degradation is related to production and consumption of coal. Overall energy trade includes large imports of crude oil and natural gas from the USSR and large exports of hard coal, two-thirds of which was directed to convertible currency markets in 1986. Poland remains a net energy exporter in physical terms, but is already a net importer in value terms.

4. Geological conditions for hard coal mining are very difficult. Even with a substantial injection of foreign exchange for spare parts and equipment, future production will be at best static. The rate of decline of hard coal exports will therefore depend critically on the speed with which other sources of primary energy can be developed and exploited, and on the impact of the economic reform on the efficiency with which energy is used in the domestic economy. Poland has substantial proven resources of lignite and natural gas, and is in the early stages of a nuclear power program based on cooperation within the CMEA. All three fuels are substitutes for hard coal, either directly or in generation of electricity and district heat. As in the case of hard coal, investment and operations in the other energy subsectors are severely constrained by lack of finance, both foreign and local.

5. Energy conservation performance has been weak. In the energy supply industry itself, transmission and distribution losses are above Western European standards in nearly all subsectors--electricity, gas, oil refining, and in particular, district heating. The main obstacle to loss reduction is lack of investment finance. With the exception of petroleum products,

consumer energy prices are heavily subsidized, with prices typically in the range of 10-50% of economic cost. Compared to industry, household consumers benefit from higher subsidies and less severe rationing. As a result of cost-plus pricing, lack of hard budget constraints and a bias towards maximizing operating costs, industrial consumers have a weak response to increased energy prices. This responsiveness is further weakened by shortages of materials and foreign exchange. Implementation of the economic reform is therefore a pre-condition for successful energy conservation program (price increases and conservation investments) in the industrial sector.

6. In the coming decade, it is expected that hard coal production will decline from the present level of 192 mtpy. The decline in production is expected to be in the range of 7-13 mtpy by 1995, depending on the level of investment in existing mines during the 1986-90 period, which in either scenario represents a very large investment. This does not take into account the significant investment required to complete three mines currently under construction and to continue development of a further five mines scheduled for completion in the 1991-2000 decade. Initial mining experience shows that some of the new mines under construction in the Lublin field may not be economic due to unexpectedly high ground pressures, and further development of the field should be postponed until the viability is proved. The investment program for the hard coal sector also needs to include small, but very important investments to mitigate the effects of coal use through construction of washeries, briquetting plants and treatment of saline mine waters.

8. Electric power investment is centered around increases in generating capacity, mainly from nuclear plants. The first of two 465 MW VVER in the nuclear plan is currently under construction. While their basic design is similar to certain other reactor designs found in the West, the method of containment is a cause of environmental concern. Electricity is severely rationed, and will continue to be so even if all projects in the present power plan are commissioned according to schedule. The impact of possible future electricity price increases is already built into the load forecasts. Under these circumstances, it is essential that the present power plan be reassessed to ensure that investment resources are being deployed with maximum possible impact. In particular, it seems likely that some resources should be re-allocated towards more rapid completion of the second lignite/power complex, accelerating rehabilitation of old coal-fired plant, and strengthening the transmission and distribution system.

9. Manufacturing. Engineering, food-processing and light industries represent about 60% of both industrial value added and employment. Engineering industries produce a wide range of manufactured goods, from light bulbs and small domestic appliances to ships and chemical plants, with a major emphasis on transport equipment and engineering products (which contribute over one third of industrial value-added). Poland has considerable industrial capacity in most engineering products, particularly machine tools and electrical components. In addition, Polish industry produces a large supply of basic materials and components such as castings, forgings, nuts and bolts, and fabricated steelwork. The chemical industry has grown substantially in

the past 25 years, doubling its share of industrial value-added, mainly as the result of the growth of basic chemicals such as sulphur and the expansion of the production of fertilizers, petrochemicals, plastics, pesticides and pharmaceuticals. The shares of light industry and food-processing have been declining.

10. Total manufacturing exports is dominated by engineering products (about 45%) and chemicals (about 11%). Engineering exports include a wide range of products (such as machinery, transport equipment, cutting tools, construction equipment, laboratory equipment, medical equipment, etc.), whereas chemicals is dominated by sulphur and pharmaceuticals. The composition of overall industrial exports has remained almost unchanged during the past 15 years, except for the slight increase in chemicals that compensated for decreases in the shares of light industry and food processing. Exports to on socialist countries grew by about 10.7% in 1986--the best performance in the last four years--, but they still were about half the 1981 level. The loss of convertible currency markets, due partly to suspension of licensing agreements with Western partners and to the incapacity of Polish exporters to ensure timely and regular supply to Western markets, seems to have been aggravated by a fall in product quality as a result of the forced substitution of imported inputs and raw materials.

11. Because of the lack of modern production technology, the engineering industry is best suited to volume production of standard products; the subsector requires considerable new investment in order to achieve the flexibility to accommodate model changes or new lines. Common deficiencies in all industrial subsectors are the lack of modern measuring and control instrumentation and of automated systems for monitoring employee efficiency, because the existing capital equipment predates the introduction of these technologies.

12. Poland has also made inadequate advances in product technology. In a market characterized by almost no foreign competition and by shortages of most industrial products, domestic consumers are prepared to buy virtually anything that domestic industry produces. The loss of competitiveness of Polish products on western markets is a clear indication of this weakness. Furthermore, nearly half of domestic engineering production is investment goods for other domestic manufactures, thus spreading the adverse effects of poor product technology in engineering to the rest of the industrial sector and is a major constraint to efforts to increase efficiency of domestic producers which use Polish capital equipment.

13. Production efficiency and profitability of individual enterprises are obscured by a complex system of taxation, subsidies and price controls. Enterprise management is characterized by having more technical than financial or economic expertise. This and the systemic distortions, result in investment decisions which are not necessarily the most efficient. Although the Government seems to have identified correctly the main needs for resource reallocation, i.e., towards projects which modernize industry, create

industrial linkages, complete existing projects, save materials and energy, increase the supply of intermediate goods, and expand exports, the actual pattern of investment continues to reinforce the existing capital-intensive and vertically integrated structure of industry.

Agriculture

14. Agriculture provides about 16% of national income and employs about 29% of the labor force. Unlike other Eastern bloc countries, the private sector predominates, accounting for about 75% of total cultivated area and production. Private farms are for the most part small, poorly equipped, and characterized by low productivity. Government presence is pervasive and the incentive system is largely government-structured, although private markets do exist for some commodities. The food processing sector (largely state-owned) is restricted by outmoded technology and insufficient capacity, resulting in poor quality products and large post-harvest losses. Agriculture (mainly agro-processing) provides about 10% of total export earnings and the sector's external trade is nearly in balance, but this is forced by the limited availability of foreign exchange for imports.

15. The potential for a stronger contribution to the national economy is considerable. This includes expansion of convertible currency export earnings, import substitution and more efficient use of resources, including release of some labor to the nonfarm economy. One of the major constraints to greater productivity growth is the quality of the land base and its inappropriate utilization. Both land and labor productivity are low and have been increasing only slowly. Significant improvement will require broader adoption of more advanced technology, greater availability of specialized production inputs, as well as fundamental changes in the price mechanisms and structures.

16. The price regulation system for both inputs and output have been a major instrument of agriculture and social policy seeking to achieve income parity for previously disadvantaged rural populations. The present system is a burden on the Government and results in a misallocation of resources, as it entails the payment of large subsidies to suppliers of inputs and also to producers of those agricultural products whose procurement prices are high. This is a politically sensitive issue since it involves a large number of private farmers for whom farming is a political as well as economic choice.

17. Agriculture and the food complex are allocated almost one-fourth of the planned five year investment budget and receive a significant share of all direct state subsidies. Nonetheless, the sector is plagued by infrastructure inadequacies, as well as shortages of other capital items. Sharp selectivity will be needed in central investments, to ensure the highest returns, including carefully re-evaluating proposed investments in irrigation and drainage programs where the average cost per hectare benefitted appears to be very high in relation to potential increases in output. Although the scientific base for agriculture appears quite strong, systemic and institutional difficulties (research, extension, credit and marketing) impede the large private sector from benefiting from this advantage.

Infrastructure

18. Transport. As in most other East European economies, railways constitute the backbone of the transport system in Poland, having a far greater role than in market economies, especially for freight, where it accounts for about 70% of total traffic, and also for about 30% of passenger transport. The Polish railways is a large organization, also by international standards, employing about 400,000 staff and transporting as much freight as the French and German railways combined and as much passenger traffic as either of them.

19. The railways operate on a generally high technical level, the consequences of postponed investment (due to insufficient availability of foreign exchange) are starting to show as serious bottlenecks. One example is the case of poor track maintenance because of the lack of track maintenance equipment, especially in the Silesian coal mining area. Another is the low availability ofrolling stock, due to inadequate maintenance facilities and equipment. Signalling equipment on many main lines are obsolete and should be upgraded. The planned investment program appears for the most part to be reasonable, although we would query the rapid continuation of the railway electrification program which will bring limited returns at the margin.

20. In contrast, roads and road transport are relatively underdeveloped and do constitute, and will do so even more in the future, a constraint to efficient functioning of the economy. This applies especially to the use of multimodal transport, including containers. This will need both organizational and equipment change and modernization. Urban public transport is extensive, but needs continuing important investments to cope with increased urban populations and to complete a number of unfinished projects.

21. The maritime secor (including ports) is generally well functioning, although there are some investment needs in port equipment. The modern container facility at Gdansk is not balanced by a corresponding level of service on the long transport side, due to insufficient adaptation of both rail and road to operate container traffic. Development of container traffic is important for the maintenance of reliable commercial relations, especially export.

22. Telecommunications. The telecommunications network is severely underdeveloped and constitutes a significant constraint on overall development. The sector has not organized itself to take full advantage of existing domestic resources and existing technology, available from its own equipment manufacturing capacity. Current plans provide for slow growth and no change in the institutional structure and modus operandi. Thus, the gap between demand and supply will widen and the standard of service will deteriorate further.

23. Housing. The two dominant features of housing in Poland are shortage and subsidies. Housing output in Poland has in relative terms been lower than that of almost all countries with similar income. The result is that among all European countries, Poland ranked last in terms of the number of housing units relative to households. The shortfall finds expression in doubled-up households and long waiting lists for state and cooperative housing, with average waiting times for housing in large cities reported to be 14-15 years. Productivity in production of housing is low and decreasing, with the average completion time for socialized housing increasing from 17 to 27 months.

24. Notwithstanding this poor performance, housing subsidies constitute a major share of current Government expenditure -- 13% of Government expenditure or 3% of GNP, and that excludes the off-budget subsidies in the form of reduced interest rates for housing loans, which in themselves reach about 1-2% of GNP. The perverse effects of the high subsidy policy constrains the Government's capacity to produce greater number of units, and the systemic constraints prevent the private sector from filling the gap.

25. Expenditures for housing among the population in existing housing is extremely low by international standards. This suggests that household's capacity to increase spending on housing is considerable, and as a result there is scope for major reductions in housing subsidies and for financing expanded resource allocation to housing by households themselves.

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 23, 1987

TO: Policy Committee

FROM: R. Picciotto, Director, Planning & Budgeting Department

EXTENSION: 38440

SUBJECT: Budget Priorities and Framework

1. As preparation for the Committee of the Whole meeting on budget priorities, Mr. Murli and I have met with a number of Executive Directors (see Annex 1). As expected, many Directors voiced skepticism about the justification of real budget growth, criticized the lack of information in the paper regarding efficiency savings and felt that, even at this early stage, management might have seen fit to articulate specific proposals for deployment of budget resources within alternative envelopes of aggregate budget growth.

2. Thus, it is clear that Executive Directors do not feel comfortable with the hard choices sketched in the budget priorities paper. Nevertheless, the tone of all meetings was reasonable and constructive and a number of Part I as well as Part II Directors expressed the opinion that they might be willing to support some growth in real terms provided management could bring to the table convincing evidence about:

(a) redeployment of resources and explicit exploitation of reorganization efficiencies;

(b) articulated proposals to meet the priorities set forth in the budget policies paper; and

(c) clear evidence of movement on strategic initiatives.

3. How much budget growth will, in the end, be acceptable is hard to gauge. My tentative sense of what was said is that a "no real growth" budget (which would deliver GCI/IDA-8 lending targets as well as basic clients' services) would be welcome. A 1% real growth scenario would require considerable justification and discussion. A 2% real growth budget and above would be downright unpopular. It would also appear that confirmation of reorganization cost savings equivalent to a 3 year payback period (a point specifically made by the UK Alternate) would be helpful to the budget debate.

4. In light of these reactions - and without prejudice to the outcome of the COW meeting - it is clear that the Executive Directors will be expecting facts and figures on efficiency and redeployment proposals as well as a clear sense of operating and financial programs priorities and convincing evidence on progress of new initiatives when we go back to the COW on the budget framework. Therefore, Units will have to furnish specific information to PBD on these aspects before the budget framework is sent to the COW. Accordingly,and taking account of the travel schedule of PC members, we should consider revisions in the planning and budget calendar.

5. The major advantage of the revised schedule set forth in Annex 2 is that it would allow careful meshing of mid-year and budget framework analyses and provide time to compile the necessary information. Its major disadvantage is that it would severely compress the balance of the budget calendar. Under the initial schedule, we were planning to issue budget guidelines to Units on December 21, 1987. Under the revised schedule this could not take place until about January 18, 1988. This would leave only about two months for the preparation by Managing Units of detailed briefing materials to the COW about FY89 program and budget proposals. These COW briefings are planned for April 11-15 and must take place around that time if we wish to get the final budget document approved before the end of the fiscal year.

(RPicciotto/pr&frmwork:dt#11)

Paper for the Committee of the Whole on FY89 Priorites and Budget Policy Directions -- Consultations with the Executive Directors

1. In consultation with Mr. Thahane, Messrs. Picciotto and Murli called on some of the Executive Directors (or their Alternates) to get their preliminary reactions to the paper on priorities. Not all Directors could be met because many were away from Washington and some did not respond.

2. While the reactions were varied, reflecting the particular interests and concerns of the various constituencies, some general themes emerged as noted in the covering memorandum.

3. While skeptical, Mr. Draghi (Italy) was not entirely opposed to a growth in the administrative budget provided it was properly justified. He thought, however, that the paper was too tentative in its discussion of potential savings and too neutral in its treatment of issues. He thought it would help the discussion if the management's point of view could be made clearer in the oral presentation. He expressed concern about the references in the paper to the share of adjustment lending, stressing that he regarded 25% as a firm ceiling - not a flexible guideline.

4. The meeting with Mr. Potter (Canada) was constructive. He thought that the issues discussed in the paper were the right ones and indicated he was not in principle averse to budget growth if justified by a clear demonstration that no stone had been left unturned regarding possible improvements in efficiency. He also felt that the "bottom line" of the profit and loss statement had to be kept in mind in looking at the administrative budget, as noted in the paper. Mr. Potter was particularly interested in the Bank's budget and planning processes and felt that the Board Budget Committee should help review these. He saw the Budget Committee's role as not investigative but supportive. He regarded the travel policy question as important and worthy of early resolution, although he recognized its emotive nature. Finally, Mr. Potter said that he would be prepared to speak first on the priorities paper, in order to set a constructive tone to the discussion. He was not discouraged from doing so.

5. The meeting with Mr. Myers (US), which started rather negatively, ended on a somewhat more constructive note. Mr. Myers indicated he was reflecting the tentative reactions of the Treasury, but said there could be more comments later. He stated that the paper was clearly tendentious. It looked like an attempt to soften up the Board for a large budget increase in real terms. He remained unconvinced about the need for any increase. He would have liked to see in the paper a clear statement about the savings to be expected from the reorganization and a better sense of future efficiency

increases. There was very little likelihood of the US agreeing to a cut in Bank activities related to poverty alleviation, the environment or any of the other important initiatives discussed in the paper. So it was up to the management to find areas where efficiencies and savings could be achieved. Mr. Myers also expressed keen disappointment with the present management position on travel, and said this made it extremely difficult for his chair to defend any increase in the Bank's budget. As regards other issues, Mr. Myers showed interest in the possibility of pricing and charging for some of the Bank's services to its clients (EDI, etc.). Like Mr. Potter, he stressed the importance of maintaining Bank profitability. As the discussion proceeded, Mr. Myers softened his position somewhat and acknowledged the political dimensions of some of the issues he was commenting upon. He also conceded that the FY88 budget was indeed tight, especially with the weakening of the dollar. In fact, he thought this last point, if valid, might be highlighted in future budget discussions.

6. Mrs. Rubio (Spain) was generally positive about the paper. She said that in her view, the principal criterion that a proposal for growth in the budget would have to meet would be whether this would help to strengthen the pipeline and provide better services to the Bank's clients. Among the latter, she regarded aid coordination as very important and expressed concern that a Vice President had still not been appointed for Financial Intermediation. Once such a person was on board, she hoped that the Vice Presidencies for Coordination and for Financial Intermediation would be merged. On adjustment lending, her view was that the figure of 25 percent should be regarded as the ceiling. Several (but not all) of her countries were interested in adjustment lending from the Bank, but she believed that the Bank should be sensitive to the higher risks associated with such lending. Mrs. Rubio was equally positive about the reorganization. She said that she could already observe the benefits of an improved country focus and greater accountability of Bank managers.

7. Mr. Rahman (Bangladesh), and his Advisor Mr. Vasudev (India), were interested in Management's view of what the Bank's output was and how it could be measured. They pointed out that the number of Bank operations had not changed much in the last five years, yet the budget had gone up considerably. They wondered why management was now linking lending volume so tightly to the size of the budget. While the right balance between lending and other client services could be examined, it was not clear what the basis was for concluding that Bank lending levels would have to be cut if budget growth did not materialize. As regards other issues raised in the paper, they believed that a 25 percent share should be the ceiling for adjustment lending. On poverty alleviation, they enquired whether the Bank had given any thought to making available additional resources to the affected countries, on concessional terms. The setting up of internal task forces was not enough. Lastly, on the question of possible contracting out of Bank services, they stressed that care should be taken to protect institutional interests and not to weaken the international character of the Bank.

8. Mr.Xu stressed that any growth in the Bank's budget would need to be properly justified. He recognized that the current global environment made it difficult to be specific about the medium term. Nevertheless, he found the arguments on the paper somewhat vague in terms of the budget choices to be made. More specifically, he said that he would need answers to the following questions before he could advise on whether budgetary growth was appropriate:

(a) What are the management's own priorities? What adjustments would the management recommend if there was to be no increase in the budget?

(b) What has been the experience with the current year's budget? Is it adequate to deliver the agreed output?

(c) What is the status of the savings expected from the reorganization?

Mr. Xu also mentioned that he and the other Executive Directors would be very interested in receiving a briefing on PPR's work programs.

9. Mr. Al-Sultan stated that in his opinion, the budget "should not stand in the way" of the Bank doing what was necessary, provided costeffectiveness could be ensured. But he had serious doubts as to whether the budget had been "squeezed enough" and referred in particular to the problem of excessive travel (which he viewed as potentially more serious than class of travel) and to the potential for economies in internal support services (especially the Bank's own procurement). He expressed interest in receiving cost data on Bank services to clients. On adjustment lending, his view was that it should not exceed 25 percent of total lending.

10. Mr. Faint had received detailed comments from H.M. Treasury. His general comment was that while the paper was an improvement over last year's, the presentation of budget priorities was not very illuminating since the cost implications of the different options had not been worked out. His authorities wished to be reassured that the paper was not a call for unrestrained budget growth. They believed that the Bank should look for continuing efficiency savings and should identify areas targeted for future gains. They also recognized the reductions carried out in the FY88 budget and hence had softened somewhat their previous stand against any real growth on the budget. Nevertheless, they were of the view that any real growth in the medium term required strong justification. On other issues, Mr. Faint reiterated the expectation of his authorities that the direct costs of the reorganization would be recovered in three years. He was sympathetic to the allocation of additional resources for economic and sector work and for financial programs. On the other hand, he felt that more of the Bank's technical assistance might be provided as part of lending. He also believed that the commercial banks should take greater responsibility for coordination in the HICs. Finally, he noted that travel policy was being reviewed by the Board Budget Committee and said he did not intend to raise the question he had on this topic in the Committee of the Whole.

Annex 2

BUDGET FRAMEWORK AND MID-YEAR REVIEW
Summary Calendar of Events

Present		Proposed	
December 4	FY89 Budget Framework Issues Paper sent to Policy Committee.	December 4	Draft FY89 Budget Framework Issues paper sent to PC members.
December 10	PC discussion of Budget Framework Issues paper.		
		December 14	PC Discussion of Budget Framework Issues paper.
December 18	Draft COW Budget Framework Briefing paper sent to PC.		
December 21	PBD issues FY89 budget guidelines to Units.		
December 23	Briefing paper on Budget Framework sent COW.		
January 4	Units submit to PBD mid-year review data.	January 4	Units submit to PBD mid-year review data and Budget Framework Inputs data.
January 15	COW conclusion of FY89 Budget Framework.	January 15	PBD Issues draft Mid-Year Review and Budget Framework Briefing COW paper to PC.
		January 18	PBD Issues FY89 budget guidelines to Units.
January 19	PBD issues mid-year review to PC.		
		January 20	PC considers Mid-Year Review and draft COW Budget Framework Briefing paper.
January 22	PC considers Mid-Year Review.		
February 1	Mid-Year Review sent to the Board.	February 1	PBD circulates to Board a consolidated Mid-Year Review and Budget Framework Briefing paper.
February 22	Board considers FY88 Mid-Year Review.	February 22	Board considers FY88 Mid-Year Review and COW considers Framework Briefing paper.

NOVEMBER 18 MTG.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 25, 1987

TO: Mr. Moeen Qureshi

FROM: Barber Conable BBC

EXTENSION: 72001

SUBJECT: GABON - Country Strategy Paper and SAL Initiating Memorandum

1. As I agreed with President Bongo of Gabon in August, we will initiate lending to Gabon with the preparation of a Structural Adjustment Loan.

2. Following the review of the Gabon-CSP and the SAL initiating memorandum, I would like you to proceed along the following lines:

(a) I agree to a loan size of US $40 million. The size of the first tranche should reflect the upfront macro-economic and sectoral policy reforms to be achieved over and above the IMF reforms linked to standby programs, i.e., should not exceed $10-15 million under present conditions.

(b) the loan conditionality and policy matrix to be developed is to include:

- as upfront action and condition of first tranche release: agreement on a 3-year public investment program and implementation of initial measures on tariff, price/wage and parapublic enterprise reforms.

- for release of the second tranche: substantial progress toward comprehensive price, tariff, parapublic enterprise and sub-sectoral reforms. Environmental issues and problems of disbursement control should also be addressed.

3. I suggest that you limit, in the coming months, staff input to the preparation and supervision of the proposed SAL. If appraisal, negotiations and first tranche release proceed satisfactorily, I would like to review with you again the size and composition of the FY89/90 lending program and its relation to continued progress under the SAL.

cc: Policy Committee Members
Mr. Jaycox

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 19, 1987

TO: Files

FROM: Marianne Haug, EXC

EXTENSION: 73585

SUBJECT: Minutes of the Policy Committee of November 18, 1987

Members Present
Messrs. Conable, Hopper, Qureshi, Ryrie, Shihata, Stern, Thahane, Wapenhans

Other Staff Members
Messrs. Choi, Dubey, Jaycox, Kavalsky, Stanton, Tanaka, Wood, Yurukoglu, Mrs. Haug

Alternative Repayment Terms

Mr. Conable opened the meeting by asking Mr. Stern to comment on the content and purpose of the paper. Mr. Stern reminded the Committee of the previous agreement to resolve the repayment terms issue once the GCI was concluded. Mr. Stern stressed that it was important to clarify as soon as possible that any liberalization of terms would result in certain costs in capital. The technical note described such costs, and no further discussions were envisaged at this point.

Mr. Qureshi concurred with Mr. Stern'strategy. Mr. Qureshi's major concern was that the approach suggested in the paper would not necessarily represent his preferred approach. From the Operations perspective, the extension of the grace period constituted the critical element in the liberalization of terms for highly indebted countries and poor countries. The extension of maturities would represent, if possible, a second important variable of terms liberalization. These measures would respond more effectively to the debt profiles of borrowing countries, and would contribute more significantly to the competitiveness of the Bank. While the extension of grace period could be an item of contention with the US and some developed countries, Mr. Qureshi considered that sufficient support could be gathered and that the costs of such approach would not be significantly higher than those of the proposed approach.

Mr. Stern agreed that the extension of the grace period would be the most powerful measure to address the situation of highly indebted middle income countries. Mr. Stern considered that the lengthening of the grace period beyond a five year period would lead to protracted discussions, and that changes proposed beyond the existing framework of 15 to 20 years maturities and 5 year grace period would be likely to meet with opposition from the US. Mr. Qureshi felt that the US was not opposed systematically to a change of structure, but was concerned about the costs of such changes.

Mr. Shihata felt that the paper did not have a consistent presentation, and wavered between a logical approach, based on borrowers' needs, and a realistic approach which examines possible alternatives within a given resource ceiling. Mr. Shihata considered also that the comparison of IBRD and commercial bank terms was misleading since it did not take into account differences in disbursement pace. Mr. Qureshi felt that the point could be made that terms are not easily comparable, but that the table on page 3 of the paper was basically correct.

Mr. Wapenhans agreed with the content of the paper and the tactical approach to the repayment terms issue. Mr. Wapenhans noted, however, that exposure represented an important constraining element in examining alternative repayment terms which was not mentioned in the paper. Mr. Stern agreed with Mr. Wapenhans that this represented an underlying problem. Mr. Qureshi perceived exposure as a distinct issue in the near term.

Mr. Thahane mentioned that Executive Directors had several questions concerning the technical notes, and was concerned that Directors could interpret the notes in different ways. Mr. Stern replied that staff had met with most Directors to discuss the previous technical notes, and that arrangements would be made to discuss this note also.

Mr. Wood stressed that the range of alternative repayment terms being currently examined fit within current policies. Changes beyond the existing policy framework would be in conflict with the approach adopted for the IDA-8 replenishment. In addition, in its dealings with Congress, the US administration has been operating on the assumption that the current policy framework would be maintained. Changes in this framework, such as the lengthening of the grace period, should be dealt with immediately. Mr. Qureshi specified that such decision need not be taken now, but that more precise work on borrower debt profile should be made as a basis of decision. Mr. Stern considered there was no possibility to consider the lengthening of the grace period beyond five years.

Mr. Shihata mentioned the linkage between repayment terms and the arrears issue by noting that an increase in arrears would affect the ability to extend liberal terms. Mr. Stern felt this issue had been addressed in previous papers which dealt with the paid-in capital question and stressed the importance for borrowers to stay current.

Outline of the Report on IBRD General Capital Increase

Mr. Wood introduced the outline, mentioning that it assumed no significant changes would result from the discussions on technical matters with the Executive Directors. Mr. Conable wondered about the magnitude of the paid-in share indicated in brackets in the outline. Mr. Stern noted that the sensible range for the paid-in share would be situated between 2.5 and 5%, and that a share over 5% was not conceivable. Mr. Qureshi considered that the paid-in share should not be turned into a major issue, and that a share between 2.5 and 3% would constitute a very strong signal of support to the Bank. Mr. Wood noted that the numbers in the document should not be viewed as management's proposal and would be the outcome of

negotiations. Mr. Wood mentioned also that a share of 4% represented an absolute ceiling for the US, as 4% of an US$ 80 billion GCI would be equivalent to past budget allocation.

In relation to para. 13, Mr. Shihata commented that members could not be prevented from subscribing to their regular shares. Mr. Stern considered that it was anomalous to offer subscriptions to members who did not honor their obligations. Mr. Shihata stressed that members are not being offered those shares, but are entitled to them.

With reference to para. 10, Mr. Shihata further considered that the introduction of a paid-in portion for membership shares could be controversial since the purpose of these shares is mostly related to the voting structure. Mr. Stern mentioned that other regional development banks had different practices in this respect. Mr. Stern remarked also that the issue was already contentious as the US opposed membership shares and Germany was against free membership shares, while some small countries could have payment difficulties. Mr. Stern finally mentioned that the objective of protecting the membership of small countries should provide a sufficient basis for consensus.

In relation to para. 12, Mr. Shihata considered the non-extendable subscription period of one year to be too limited, and suggested that a longer subscription period with no extension be defined.

Mr. Conable agreed to proceed with the proposed report outline and detailed discussions with ED's as proposed.

Gabon - Country Strategy Paper

Mr. Conable opened the discussion by stating that while he had expressed Bank willingness to assist Gabon during his meeting with President Bongo, he did not recall making any commitment on either a pipeline or a SAL. Mr. Jaycox pointed out that the existence of potential new oil sites further narrowed the window of opportunity for initiating substantial adjustment work. Oil companies were investing an estimated US$800 to 900 million. This, together with the rumor of a possible upcoming SAL, could be providing Gabon with access to commercial banks. Mr. Jaycox pointed out that stakes were high since the introduction of a structural adjustment process in Gabon would facilitate work in the subregion. In response to a question by Mr. Conable on the CFA Zone issue, Mr. Jaycox replied that the situation was getting dire and the pressure on the French Treasury was mounting.

Mr. Ryrie mentioned that IFC was getting involved in Gabon with estimated investments of US$84 million in oil, a manganese port, and wood. He favored the implementation of a SAL, and would foster further IFC collaboration with the Bank country team. In response to a question by Mr. Conable on staff commitments, Mr. Jaycox noted that a minimum staff allocation was required to follow through with the current work, and that the pace should be accelerated to develop sectoral work.

Mr. Stern considered that both the envisaged pipeline and the SAL were too large. While he agreed with Mr. Qureshi on the need to support Gabon, Mr. Stern did not perceive the need for a fast disbursing loan, and noted that the SAL would not obtain any significant reform beyond the IMF standby until late 1988. Mr. Stern challenged the appropriateness of a SAL

and of a loan size increase by noting the high allocation per capita, limited knowledge of the situation, the resulting weakness of the program, delapidated infrastructure, and the difficulty to trace the uses of fast disbursing loans. Mr. Stern felt that the size of the first loan should be reduced back to US$35 million, and that the strategy should focus on sector investment. In addition, if a SAL was considered, it should go significantly beyond the IMF package with an agreed PIP, tariff changes as a condition of Board presentation, and a clear understanding on directions to be adopted in relation to the public sector.

Mr. Qureshi mentioned that little is currently known on Gabon, and that priority should be placed on initiating a comprehensive dialogue. Mr. Thahane agreed with the size of the operation, but expressed concern on the sustainability of reforms once oil revenues increase again. Mr. Shihata considered that Gabon could not be singled out based on the allocation per capita criterion. Mr. Shihata insisted, however, on the need to have a SAL package going significantly beyond the IMF package, and on the need to consider the corruption issue. Mr. Jaycox described progress to date and mentioned close Bank-Fund collaboration in the case of Gabon. Mr. Jaycox further stated that he would not consider any investment in Gabon in the absence of a SAL, and that the real issue was to seize the current window of opportunity or face not being part of the adjustment process in Gabon.

Mr. Hopper forcefully opposed a SAL as he considered the knowledge base to be too limited. Mr. Hopper noted that the history of Gabon showed that reform would be reversed as soon as the window of opportunity closes, and that the loan would only assist to ease the burden of budgetary decisions, providing no balance of payment support or support to infrastructure. He considered that the current documents did not present a significant case for a SAL, and recommended that the program be oriented towards specific investments or sectoral adjustment.

Mr. Wapenhans felt that the importance of the Bank's role resided in its technical assistance and guidance to the adjustment process, rather than in the size of the loan which was anyway negligible when compared to overall financial flows. Mr. Wapenhans emphasized the importance of the presence of the Bank, and stressed the need for an upfront package of policy measures. Mr. Dubey mentioned that agreement on the PIP and tariff reform were specifically mentioned as a condition of second tranche release, and that parastatal reform objectives were already spelled out in a draft development policy letter. Mr. Stern pointed out that every SAL which had been made on the basis of a window of opportunity argument had not been successful. Mr. Jaycox mentioned that a smaller first tranche could be considered.

Mr. Conable thanked the PC members for their discussions and varied points of view. He noted that he intends to continue to consider a first lending operation to Gabon as promised to President Bongo in August, but will review once more specific loan size, tranching and conditionality.

<u>Paper on "Board Consideration of the Bank's Country Lending Strategies"</u>

Mr. Thahane noted that this paper represented the heart of the Board Procedures Committee exercise. Mr. Thahane mentioned that Part II countries would be meeting next week to discuss this proposal. It is expected that Part II countries would be opposed to the proposal, although the way in which the opposition would be stated remains unknown.

Mr. Shihata felt that this proposal contained a dramatic shift of decision-making from management to the Board, as the Board would ultimately intervene in setting lending size over a period of time to specific countries. Mr. Wapenhans considered option (i) in para. 12 to be problematic as it would excessively reduce management flexibility, and expressed preference for option (iii). Mr. Ryrie considered that the proposal would affect conditionality and could lead to a preallocation scheme as in the European community.

Mr. Qureshi expressed concern about the content of the paper. In response to such proposal, Mr. Qureshi felt it was important to articulate a management position, and to define in what form and at what stage the Board should have an opportunity to discuss country policy. Mr. Qureshi pursued by proposing that country strategy could be discussed when the first project to each country is presented to the Board each fiscal year. A specific short issues note could even be prepared for this occasion. Mr. Thahane remarked that such proposal had previously been formulated with the condition that the Executive Director of the concerned country agree on having such a discussion. As this condition was never fulfilled, such discussion of country strategy had never occurred. Mr. Stern agreed with Mr. Qureshi's proposal.

Mr. Thahane suggested that Part II countries could be mobilized to stop this initiative. Mr. Stern disagreed with a fragmentation between Part I and Part II countries, arguing that some Part I countries would be likely to oppose such initiative.

Mr. Conable agreed that no specific management initiative was needed, but senior management should keep each other informed throughout the interview and discussion period.

Review of the Tax Allowance System

Mr. Wapenhans informed that the IMF had already sent the paper to its Board, but that no decision had been made yet. It was agreed that the paper would be sent to the Board on a no-objection basis.

JT

POLICY COMMITTEE MEETING

Wednesday, November 18, 1987

9:30 a.m.

AGENDA

* 1. **GCI Documents**
   - Alternative Repayment Terms
   - Outline of Report of the Executive Directors to the Board of Governors

** 2. **GABON**--Country Strategy Paper cum Initiating Memorandum for a Structural Adjustment Loan

3. **Miscellaneous**

* - Memorandum from Mr. Lankester on "Board Consideration of the Bank's Country Lending Strategies" dated November 6, 1987

** - Paper on "Review of Tax Allowance System"

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* Document attached

** Document previously distributed

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Members of the Policy Committee — November 13, 1987

FROM: Ernest Stern, SVPFI

SUBJECT: GCI - Additional Documents

Attached are two further documents relating to the GCI which we would like to discuss on November 18, or otherwise receive your comments by then.

The first is the technical note on repayment terms. Technical notes are not the vehicle to state management's preferences and no recommendation is made. We have, however, costed out the various alternatives in terms of capital requirements. This highlights the high cost of a reversion to pre-1976 terms for all borrowers, and it is unlikely that agreement on this could be reached. Most likely it would be an agreement on level annuity payments for low-income countries, plus a temporary five-year grace period for others. Possibly, a temporary level annuity payment for all borrowers could find support. As Table 4 shows, the impact in terms of increased net disbursements is quite powerful.

In any event, the purpose of this note is not to reach agreement on any specific set of terms. Management plans no recommendation for the final GCI paper since we have agreed that this issue would be taken up separately after the GCI has been approved. What we are seeking is an agreement to consider a change in repayment terms, and the technical note is intended to inform members of the range of choice which lies ahead.

The second paper is an outline of the final Board paper on the GCI. We will, of course, submit the draft paper to the Policy Committee for review but would welcome your comments on structure and content at this stage to guide the drafting.

Attachments

cc: Ms. Haug

OUTLINE OF REPORT OF THE EXECUTIVE DIRECTORS TO THE BOARD OF GOVERNORS

IBRD GENERAL CAPITAL INCREASE

A. Introduction

1. This section will provide a summary of developments that led to the agreement on the size and terms of the GCI. It will make references to the CoW discussion on modalities and various technical notes distributed to the Executive Directors in the context of the GCI discussions. It will also introduce the structure of the paper.

B. Size of the Increase

2. A brief discussion on the nature of the Bank's role in the 1990s, how the IBRD financing fits in with overall external financing for developing countries will be introduced in this section.

3. This section will then present the arguments which support the proposed size of the increase. It will argue that the proposed size of the GCI is such to support a five year growth in lending capacity and provide for flexibility to allow changes in repayment terms while emphasizing the point that the size of the increase is not rigidly tied to a particular set of assumptions concerning these variables. A capital increase of [$ 85 billion ~ 705,000 shares] will be recommended.

4. In response to a request from an Executive Director for formal Board endorsement of the present practice, this section will state that disbursed loan balances are accounted against the statutory lending limit.

C. Structuring of New Shares

5. This section will argue that any equiproportionate allocation of an increase in IBRD's capital would result in a reduction of the voting power of smaller members and hence the Part II group because of the limited number of evenly distributed votes in the the Articles and in the 250 membership shares associated with the 1979 GCI. The number of membership shares (per member) required to restore 42.36 percent of total potential voting power to the Part II group will be introduced.

6. It will then propose splitting the capital increase into three components and recommend a pro-rata component of [$ 75 billion ~ 621,710 shares], a component for membership shares [$ 8.2 billion ~ 68,375 shares] and a third component for set-aside shares for new members corresponding to one percent of total shares [$ 1.8 billion ~ 14,915 shares]. References will be made to the draft resolution covering all three components.

7. If an agreement on waiving the exercise of preemptive rights for all three components cannot be reached, two resolutions -one for pro-rata and set-aside and another for membership shares- may be needed. For the membership shares component, the paper will then point out that this

component will be effective only if all members waive their preemptive rights.

8. For the base of the pro-rata increase, a uniform percentage increase in present allocations including the shares allocated under Resolution [ ] (Rao Sahib scheme) will be recommended. Number of shares to be allocated under the pro-rata component by country in alphabetical order will be listed in the section.

D. Paid-in Portion

9. Following a brief discussion on the merits of the paid-in portion, a paid-in portion of [4] percent for new regular shares will be recommended. Within the paid-in portion, [0.4] percent will be in gold or foreign exchange and [3.6] percent in local currencies.

10. A paid-in portion of [1] percent for membership shares could also be recommended. Only [0.1] percent corresponding to the portion payable in foreign exchange and gold would be called. [0.9] percent payable in local currency for membership shares would not be called.

11. Because of the concern expressed by several Directors for the uneven treatment of releases of local currency subscription payments, the adoption of a uniform release policy based on balance of payments criteria will be proposed.

E. Timing of Subscriptions

12. This section will point out to the pressures on the headroom and SLL and propose that the Board of Governors approve the resolutions by [June 30, 1988]. It will set a non-extendable subscription period of one year from the effectiveness for membership shares and of five years for regular shares. A set of specific conditions regarding extensions for subscription period for regular shares will also be introduced.

[In order to get substantial initial subscription, the following or a similar provision can be introduced. If members do not subscribe to one fifth of regular shares allocated to them at the end of two years from the date of effectiveness, these shares will be deemed released.]

F. Other Provisions

13. This section will set out other rules pertaining the GCI. It will propose that members which have loans in non-accrual status with the Bank will not be allowed to subscribe regular shares until they become current in their obligations.

Attachments

Voting Power Table
Resolution(s) [ ] 1987(8) General Capital Increase

TECHNICAL NOTE

ALTERNATIVE REPAYMENT TERMS

Section I. Introduction

1. The purpose of this note is to respond to the questions concerning implications of changes in IBRD repayment terms raised by the Executive Directors at the meeting of the Committee of the Whole on the modalities of the GCI on July 30, 1987. The note is organized as follows:

- Section II describes the evolution of current repayment terms and recent discussions by the Executive Directors on possible alterations of these terms.
- Section III describes how a change from current repayment terms to level annuity repayments and/or longer grace periods would affect the debt service profile of a typical IBRD loan.
- Section IV examines the implications of a change in repayment terms for debt service obligations of the IBRD borrowers and for net flows of capital between the IBRD and borrowing countries.
- Section V analyzes the impact of alternative repayment terms on IBRD capital requirements.
- Section VI discusses the impact of alternative repayment terms on IBRD's borrowing requirements and on the risk characteristics of its loan portfolio.

The information presented in this note is technical in nature. No policy recommendations are made.

Section II. Current Repayment Terms

2. Prior to 1975, IBRD repayment terms were set on a loan-by-loan basis according to the characteristics of the project to be financed by the loan and were based on a level annuity type system. Principal repayments were made in gradually ascending amounts, calculated to yield a series of constant total debt service payments (principal repayment plus loan charges) during the repayment period. During the FY72-FY76 period, grace periods and final maturities for IBRD loans averaged 4.5 years and 21 years, respectively.

3. In early 1975, in an attempt to raise the lending level that could be supported by the then-existing capital base of the Bank, it was decided to limit the final maturity of loans to countries with relatively high income levels to 15 years under normal circumstances. In FY76, the policy on repayment terms was further tightened by shortening overall grace periods and final maturities so as to raise the sustainable level of lending. At this time two modifications of repayment terms were adopted:

(a) amortization pattern was changed from a level annuity (with principal payments increasing and loan charges decreasing over the repayment period) to one involving equal principal payments; the impact being that countries have higher debt service payments in the earlier years of the loan; and (b) repayment terms of future loans to be managed so that Bank-wide weighted averages of the grace period and final maturity would not exceed 3.3 years and 19 years, respectively.

4. In order to achieve this and to distribute the tighter repayment terms broadly in line with countries' debt service capacities, a three tier structure of repayment terms was introduced, under which repayment terms for a loan would be determined on the basis of the per capita income level of borrowing countries.[1] The current average grace period and maturity of IBRD loans are 4 years and 17.4 years respectively. The present three tier term structure is shown below:

GNP Per Capita	Grace Period (years)	Maturity (years)
Less than $ 835	5	20
$ 836 to $1,725	4	17
Above $1,726	3	15

5. Repayment terms were last changed in FY76. At that time, the changes were viewed by many countries as temporary, pending final agreement on a further capital increase. Subsequently, it was not possible to reach a consensus in favor of a restoration of pre-1976 terms. The fact that debt service capacity of many IBRD borrowers has deteriorated in recent years and that - for the heavily indebted countries - the restoration of that capacity is now seen as likely to require several years; makes it appropriate to consider whether repayment terms on new IBRD loans should be modified. The basic objective of any modification should be to bring the borrowers' debt service profile to the IBRD more nearly into line with the borrowers' expected debt service capacity.

6. Doubts about the appropriateness of current IBRD repayment terms have been raised with regard to both the low income and the heavily-indebted middle income borrowers. In case of the low income countries, the doubts are based on the hardening of the overall debt service profile which has occurred as these countries have shifted toward greater reliance on commercial financing and - especially for the blend countries - lesser reliance on highly concessional funds. The shift in debt service profile may be occurring at a more rapid rate than is consistent with these countries' longer-term needs, particularly in view of their very large requirements for investment in infrastructure and for investments addressed to the reduction of poverty.

7. The anomalous character of IBRD repayment terms extended to the heavily-indebted middle income countries is brought out by comparing these

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1/ Under the current system, some differentiation of repayment terms is permitted on project grounds. The scope for differentiation is, however, limited by the country averages based on per capita income as indicated above.

terms with the terms currently offered by commercial banks participating in concerted lending to these borrowers, as shown in Table 1.

Table 1. Comparison of Lending Terms Between IBRD and Commercial Banks for Middle-Income Countries

	IBRD	Commercial Banks a/
Maturity (years)	15.0	11.5
Grace period (years)	3.0	5.4
Estimated Average loan life b/	4.9	7.9

a/ Weighted average lending terms of commercial banks in concerted lending to middle income borrowers during 1987.

b/ Average loan life is the average of the number of years during which various lending instruments remain outstanding before being fully repaid. For IBRD, average loan life for a middle income borrower is estimated on the basis of a composite disbursement profile with a 25% share of fast disbursing loans. Average life of a fast disbursing loan (e.g., a sector adjustment loan) for a middle-income country, however, would be 6.9.

8. The IBRD grace period is roughly half of what the commercial banks have been providing to the same countries, even in cases where the Bank has been a partner in the overall financing package. Compared to the commercial banks, the average IBRD loan life for middle-income borrowers is about 3 years shorter. In addition, when compared to the time it takes to complete a typical project (between 7-9 years on the average), a 3 years grace period is relatively too short.

9. The implications of modified repayment terms for both the borrowers and the Bank have been examined in a number of documents issued over the past two years. A technical note entitled "Repayment Terms" (SecM85-848, dated July 16, 1985) provided an analysis of the implications of alternative repayment terms for net flows to borrowers and for the Bank's capital requirements. In April 1986, Executive Directors discussed a memorandum entitled "Selective Liberalization of IBRD Repayment Terms on New Loans" (R86-70, dated March 18,1986 and R86-70/1 dated March 20,1986) which considered proposals to: (i) on a temporary basis, extend grace periods for up to six years for countries implementing adjustment programs requiring debt rescheduling and/or "concerted lending" ; and (ii) allow level annuity payments with a five year grace period for low-income borrowers with 20 years maturity or alternatively a six year grace period with a final maturity of about 22 years under an equal principal repayment system on a permanent basis.

10. Several Directors felt that these proposals did not go far enough; and they favored across-the-board changes in repayment terms. Other Directors expressed their reluctance to consider changes in repayment terms separate from and in advance of negotiations for a GCI. It was decided

that further consideration of the issue would be deferred and taken up again as a part of the GCI discussions.

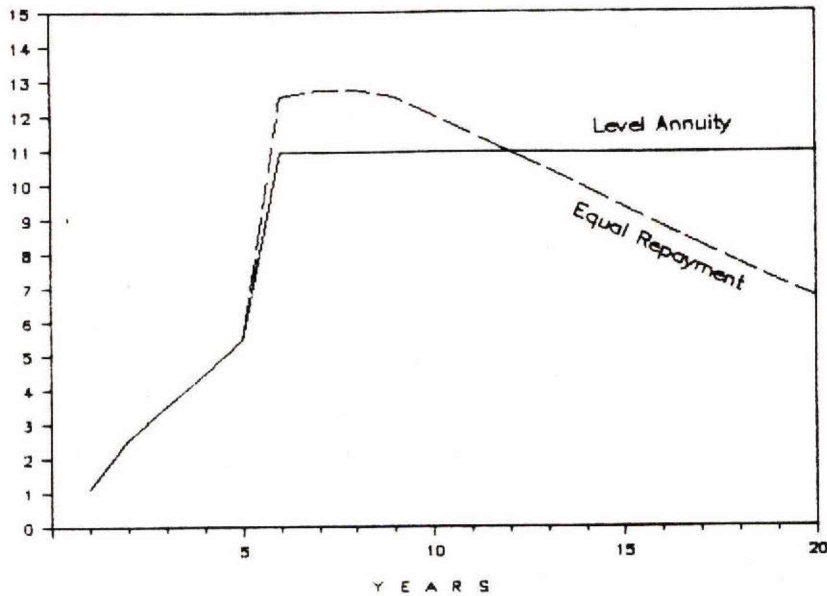
11. At the July 30, 1987 meeting of the Committee of the Whole on the GCI modalities, Directors generally recognized that a complete return to pre-FY76 repayment terms would be very costly in terms of capital requirements. Most Directors, however, expressed support for some improvement of terms on a selective basis, although a few Directors indicated that they remained to be convinced. It was generally agreed that the GCI should not be held up by an effort to determine the precise nature and scope of changes in repayment terms. What is needed as part of the GCI negotiations is only a decision in principle as to whether the financing capacity created by the GCI should be used in part to modify the repayment terms or amortization pattern of future IBRD loans. An affirmative decision would imply a willingness to accept some reduction in the eventual level of annual commitments (i.e., the SLL) in order to permit new lending to take place on terms more nearly aligned with the borrowers' debt service capacity. The extent of change in terms would be subsequently decided by the Executive Directors in the light of the size of the GCI that is finally agreed. The details of implementation would also be left to subsequent decision by the Executive Directors.

Section III. Debt Service Profiles Under Alternative Repayment Terms

12. The alternative grace periods and maturities illustrated in this note are within the existing policies approved by the Executive Directors. They do not imply any change in the maximum grace periods and maturities beyond those currently in effect. Annexes 1, 2 and 3 show the differences in debt service payments under the current repayment system and an annuity repayment system. Under the present system, a loan to a low-income borrower (assumed to be equal to 100) is repaid in 15 equal annual installments of 6.67 each (Annex 1). Under the annuity system, annual principal payments are adjusted so as to keep the total debt service payments constant (at 10.91 per payment) after the grace period. Under the level annuity system, in the early years the bulk of the debt service payments is interest with relatively smaller principal repayments. In the latter years, as the outstanding and disbursed balance of the loan declines, these proportions shift towards the end of the loan when the bulk of the payment is principal.

13. Between years 6 and 14, debt service payments are lower under the annuity system (98.2) than under the current repayment system (105.2). The average life of the loan would be longer under the level annuity system (9.75 years) than under the current equal principal payment system (8.45 years). Loan charges over the life of the loan, however, will be higher by about 10.4 percent under an annuity system (80.7) because principal is repaid more slowly than under the equal principal system (70.3). (Figure 1)

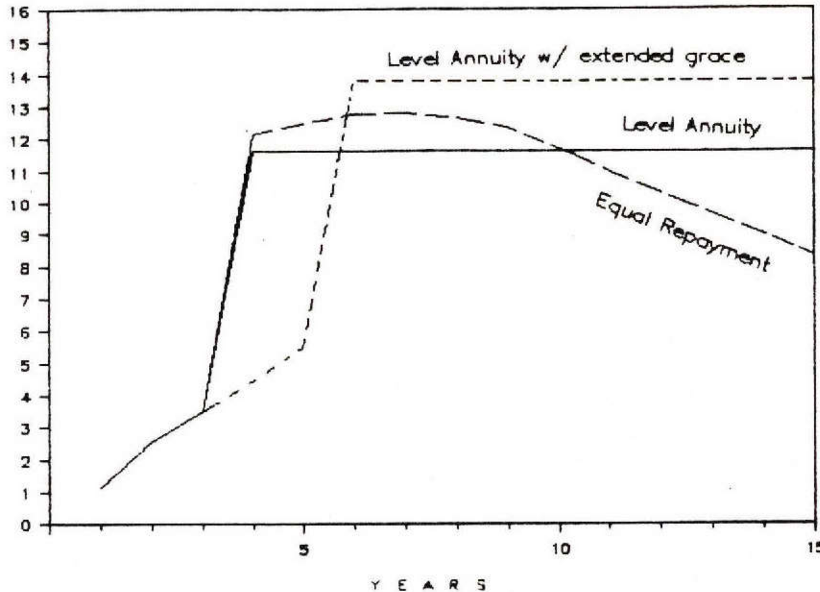
Figure 1: Debt Service Payments under Equal Principal and Level Annuity Repayment Systems for a 20-Year Maturity/5-Year Grace Loan



14. Annex 2 compares debt service payments on a typical IBRD loan to a middle-income borrower under the current repayment system (3 years grace and 15 years maturity) to an annuity system with the grace period extended to 5 years. In this example, debt service payments in years 4 and 5 are significantly lower, by about 14.7 percent under the annuity system with 5 years grace, compared with the current repayment system. However, loan charges over the life of the loan will be higher by about 12.5 percent under the annuity system than under the equal principal payment system.

15. Annex 3 shows the impact of a change to an annuity system without an extension of the grace period. Payments in years 4 and 5 are lowered by the shift to an annuity system, but the impact is obviously not as great as when this change is combined with an extension of the grace period. Because the annuity payments are stretched out over a larger number of years, the debt service burden is actually lower in years 6 through 15. During the first eight years of a 15-year loan to a middle-income country, extension of grace periods from 3 years to 5 years has, however, a greater impact than that of a level annuity repayment system without changing grace periods. Figure 2 provides a graphical comparison of the alternative repayment patterns. The impact on capital requirements - which is driven by the gross capital coefficient (as explained in Section V below) - is about 19 percent greater if a reversion to an annuity system is combined with an extension of grace period.

Figure 2: Debt Service Payments under Equal Principal and Level Annuity Repayment Systems for a 15-Year Maturity/3-Year and 5-Year Grace Loan



16. These examples assume that the lending rate remains unchanged throughout the life of the loan. If the lending rate changes, there are a number of ways in which the annuity system might be adapted. One way would be to fix the repayment schedule on the basis of the lending rate prevailing at the time the loan is committed, but reflect subsequent changes in the lending rate through changes in the interest portion of the debt service due at each payment date. Other options include readjustment of the annuity payments periodically (e.g. every three to five years) or alternatively maintaining the fixed debt service payments and to adjust principal repayments.

Section IV. Implications of Alternative Repayment Terms for Net Disbursements

17. A return to an annuity repayment schedule, an extended grace period, or a combination of these two, would increase net disbursements to the borrowers in the years immediately after expiration of the grace period, but decrease them in the later years of the loan. It is important to recognize that a change in repayment terms would have marginal impact on principal repayments (net disbursements) in the years immediately following such change. However, over the medium- and long-term, the cumulative impact on net disbursements to borrowers resulting from such changes in repayment terms can build up to a significant level. For instance, had repayment terms been changed in FY81, after the 1979 GCI, to an annuity system with 5 years grace period for all borrowers, net disbursements would have been about $2.9 billion (8%) higher during the FY81-FY87 period, based on historical disbursements data (Table 2).

Table 2: Increase in Net Disbursements During FY81-FY87 if Repayment Terms Had Been Changed in FY81 (US$ Billion)

	FY81	FY82	FY83	FY84	FY85	FY86	FY87	Total FY81-87
Net Disbursements with:								
Actual Repayment Terms	3.5	4.7	4.8	6.0	5.7	4.4	5.6	34.5
Level Annuity with 5 years grace for all borrowers	3.5	4.7	4.8	6.3	6.4	5.3	6.4	37.4
Difference	-	-	-	0.3	0.7	0.9	1.0	2.9

18. Table 3 illustrates the implications of alternative repayment systems for the projected debt service payments and for net disbursements. The calculations have been done for the base case lending scenario as indicated in the technical note entitled "Lending Capacity and Capital Requirements" (SecM87-1233, dated November 6, 1987). The base case reflects a nominal growth of an average 7.5 percent a year in commitments from FY91 onwards. For illustrative purposes, an annual interest rate of 8%, a commitment fee of 0.75%, a share of fast disbursing loans in commitments at 25%, and an annual cancellation of 2% of total commitments have been assumed. Impact on net disbursements are presented for four alternative sets of repayment terms for commitments starting with FY88. These are : (a) level annuity payments for low income borrowers only, with equal principal and unchanged grace periods for all other borrowers; (b) level annuity payments with unchanged grace periods for all borrowers; (c) level annuity payments with 5 years grace periods for all borrowers; and, (d) level annuity payments for all borrowers, but with a temporary (for five fiscal years) extension of grace periods to 5 years. Since the impact on net disbursements will not be felt before FY91, Table 3 is presented for the period FY91-FY00, FY05, and FY10.

19. Table 3 shows the differences in net disbursements[2] based on the alternative repayment terms described in the preceding paragraph over current lending terms. If level annuity payments with 5 years grace periods were adopted from FY88, the impact on net disbursements would be felt as early as in FY91. If level annuity terms were adopted for low income borrowers only, with the current terms being applied to all other borrowers, the impact on net disbursements would not be felt until FY93, since the grace periods remain unchanged from current terms.

2/ Since disbursements remain unchanged under each alternative set of repayment terms from those under the current terms, increase in net disbursements, therefore, is equal to the decrease in principal repayments

Table 3: Impact On Net Disbursements Over Current Terms

($ billion)

	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY05	FY10
Commitments 1/	20.5	22.1	23.9	25.7	27.6	29.7	31.9	34.3	36.9	39.7	56.9	81.7
Commitments in FY87 prices	18.7	19.1	19.6	19.9	20.3	21.0	21.7	22.4	23.2	23.9	28.2	33.3
Under Current Terms 2/												
Principal Repayment 3/	0.4	1.1	2.4	3.7	5.2	6.9	8.6	10.5	12.6	14.7	26.6	39.5
Interest Payment	0.9	1.6	2.5	3.5	4.6	5.8	7.1	8.4	9.7	10.9	17.4	25.1
Debt Service Payment 4/	1.6	3.1	5.3	7.7	10.5	13.4	16.4	19.7	23.0	26.6	45.2	66.5
Case A (Level Annuity for low income group only)												
Principal Repayment Difference 3/	0.0	0.0	0.0	-0.2	-0.3	-0.5	-0.7	-0.9	-1.1	-1.3	-1.5	-1.3
Interest Payment Difference	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.2	0.3	0.9	1.4
Debt Service Payment Difference 4/	0.0	0.0	0.0	-0.2	-0.3	-0.5	-0.6	-0.8	-0.9	-1.0	-0.6	0.1
Case B (Level Annuity all with Current Term)												
Principal Repayment Difference 3/	0.0	0.0	-0.1	-0.3	-0.6	-0.9	-1.3	-1.6	-1.9	-2.0	-2.0	-2.0
Interest Payment Difference	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.3	0.4	0.5	1.4	2.1
Debt Service Payment Difference 4/	0.0	0.0	-0.1	-0.3	-0.6	-0.9	-1.1	-1.3	-1.5	-1.5	-0.6	0.1
Case C (Level Annuity with 5 year grace for all)												
Principal Repayment Difference 3/	-0.2	-0.8	-1.3	-1.5	-1.8	-2.1	-2.5	-2.8	-3.0	-3.1	-3.1	-3.5
Interest Payment Difference	0.0	0.0	0.1	0.2	0.3	0.4	0.6	0.8	1.0	1.3	2.5	3.8
Debt Service Payment Difference 4/	-0.2	-0.8	-1.2	-1.3	-1.5	-1.7	-1.9	-2.0	-2.0	-1.9	-0.6	0.2
Case D (Level annuity with temp 5 year grace for others)												
Principal Repayment Difference 3/	-0.2	-0.8	-1.3	-1.5	-1.8	-1.5	-0.8	-1.1	-1.4	-1.5	-1.6	-2.0
Interest Payment Difference	0.0	0.0	0.1	0.2	0.3	0.4	0.6	0.6	0.7	0.8	1.4	2.1
Debt Service Payment Difference 4/	-0.2	-0.8	-1.2	-1.3	-1.5	-1.0	-0.3	-0.5	-0.6	-0.7	-0.2	0.1

1/ Base case projections of lending levels for FY91-FY94, assumed to grow at 7.5% a year beyond FY94.

2/ Figures refer to principal repayment, interest payment and debt service payment on commitments made starting from FY88.

3/ Since disbursements remain unchanged, decrease in principal repayments is equal to the increase in net disbursements.

4/ Debt service payments include commitment charges.

Table 4: Changes in Net disbursements Under Alternative Repayment Terms

	FY91-FY95		FY96-FY00	
	$ billion a/	% b/	$ billion a/	% b/
Level Annuity With Unchanged Grace Periods				
Low income borrowers	0.5	1.6	4.6	9.9
All borrowers	1.0	1.6	7.7	9.7
of which:				
Highly indebted borrowers	0.5	2.0	3.4	10.7
Level Annuity with Permanent 5 Year Grace Periods				
Low income borrowers	0.5	1.6	4.6	9.9
All borrowers	5.6	9.0	13.5	17.0
of which:				
Highly indebted borrowers	2.4	9.4	6.1	19.2
Level Annuity with Temporary 5 Year Grace Periods				
Low income borrowers	0.5	1.6	4.6	9.9
All borrowers	5.6	9.0	6.3	7.9
of which:				
Highly indebted borrowers	2.4	9.4	3.1	9.7

a/ Refers to the total impact over the period indicated.
b/ Refers to the percentage increase in net disbursements to that specific group of countries over the period indicated.

20. Table 4 above summarizes the impact of alternative repayment terms on different groups of borrowers during the periods FY91-FY95 and FY96-FY00, under the base case lending scenario. Changing to a level annuity system for all borrowers with existing grace periods would yield $1.0 billion increase in net disbursements (1.6% higher than under current terms) during the FY91-FY95 period. Level annuity payments with 5 years grace periods to all borrowers would yield $5.6 billion increase (9.0% higher than under current terms) during the same period. If terms are changed for low income borrowers only, net disbursements would only be $0.5 billion higher during FY91-FY95. This would correspond to a 1.6% increase in net disbursements to these borrowers during FY91-FY95. Under a level annuity system with a temporary extension of grace periods to five years for the next five fiscal years, net disbursements to all borrowers during the period FY91-FY95 would remain unchanged from the scenario in which grace period extension would be permanent. During the period FY96-FY00, however, net disbursements to all borrowers would be about $6.3 billion if the extension of grace periods was to be temporary as compared to $13.5 billion if grace periods were permanent; representing a reduction of about 53%. Similar analysis has been undertaken to measure the impact of alternative repayment terms on the highly indebted countries. The countries belonging to the highly indebted borrowers group

include low-income as well as middle- and high-income countries. Thus, net disbursements to the highly indebted countries as a group reflect the effect of different term structures which are applicable to individual countries in this group as determined by their per capita GNP levels.

21. Achieving similar increases in net disbursements under current repayment terms would require substantial increases in annual commitment levels. For instance, $1.0 billion increase in net disbursements during the period FY91-FY95 which would result from a return to level annuity repayment for all borrowers with unchanged grace periods, would correspond to an increase of about $4.0 billion in commitments in investment project lending over the period, or about $800 million a year. Similarly, to achieve an increase in net disbursements of $5.6 billion during the period FY91-FY95, resulting from the return to level annuity system with a permanent extension of grace periods to 5 years, would require an increase in commitments of about $4.5 billion each year in investment project lending.

22. Alteration of repayment terms will also have an important effect on the position of blend borrowers, especially India and China. The average terms of Bank Group assistance for these countries have been, as a consequence of the shortage of IDA resources, substantially harder than would be recommended in the absence of the severe constraint on IDA availabilities. For illustration, the mix of IDA and IBRD terms for India has already changed from 75/25 in FY81 to 24/76 in FY87. A return to an annuity system on new IBRD loans would partially offset this impact and smooth the debt service profiles of blend countries in the transition.

Section V. Capital Requirements

23. Modified repayment terms increase the capital required to support any given level of loan commitments. As shown in Annex 2, in the case of a loan with 15 years maturity and 3 years grace period (under current terms), a return to level annuity system and extension of grace period to 5 years would increase the gross capital coefficient[3] from about 4.85 to 6.35. For a loan with current repayment terms of 20 years maturity and 5 years grace, the corresponding figures for the gross capital coefficient are 8.34 and 9.45.

24. Given the present distribution of commitments to borrowers at various income levels and given the current disbursement pattern of IBRD loans, Bank-wide gross capital coefficient (average loan life) is estimated at about 6.90 years.[4] Annex 4 shows the average loan life for various income groups of borrowers. A return to level annuity system for all borrowers would increase the gross capital ratio to about 7.65. If the grace periods were to be set at 5 years for all borrowers in addition to reverting to an annuity system, the gross capital coefficient would rise to about 8.10.

3/ Gross capital coefficient is defined as the amount of capital requirement per dollar of annual lending and is equivalent to the average number of years a loan remains disbursed and outstanding.

4/ It is assumed that the share of fast disbursing loans would be 25% of total commitments and 2% of annual commitments would be cancelled. For annuity type repayment, the interest rate on IBRD lending is assumed at 8%.

25. Required size of the GCI under alternative repayment term structures are summarized in Table 5. These calculations show the capital requirements for lending growth of 5 years and 6 years which correspond to sustainable levels of lending of $23.9 billion and $25.7 billion, respectively in nominal terms, as discussed in the technical note entitled "Lending Capacity and Capital Requirements" (SecM87-1233, dated November 6, 1987).

Table 5: Required Size of the GCI with Alternative Repayment Terms (US $ billions)

	Lending Growth	
	5 years	6 years
Unchanged Repayment Terms	72.4	84.8
Alternative Repayment Terms		
Low Income:a/ Level Annuity Others: Equal principal and current grace	84.4	97.3
Low Income: Level Annuity Others: Equal principal and 5 years grace (temporary)	84.4	97.3
Low Income: Level Annuity Others: Level annuity (temporary), and 5 years grace (temporary)	84.4	97.3
Low Income: Level Annuity Others: Level annuity and current grace	90.4	104.2
Low Income: Level Annuity Others: Equal principal and 5 years grace	94.7	108.8
Low Income: Level Annuity Others: Level Annuity and 5 years grace	101.1	115.7

a/ For low-income, grace period is assumed to remain unchanged at 5 years throughout the table.

26. A temporary change in repayment terms does not require an increase in the capital base because such a change would increase the disbursed and outstanding loans only temporarily. When all the loans to which new terms would be applied on a temporary basis are fully amortized, the size of the Bank's portfolio after that year would remain the same as it would have been under current repayment terms. At that time, the average loan life would be restored to its present level. There would, however, be a need for an increase in net borrowings. Thus, if the capital requirements associated with permanent changes are considered excessive, they can be accommodated within a given size of the capital base on a temporary basis. Since the alternatives illustrated in Table 5 are not exhaustive, a number of other possibilities can be considered on either a selective or a temporary basis.

Section VI. Implications on Borrowing Requirements and Portfolio Risk Characteristics

27. Changes in repayment terms would affect the Bank's borrowing requirements in two ways. First, the reductions in debt service payments would add directly to the Bank's borrowing requirements. These reductions are shown in Table 3. If grace periods are not changed, the direct impact is negligible over the next five years and grows slowly thereafter to a maximum annual level of $1.5 billion at the end of 1990s. If grace periods for middle and high-income countries are extended to 5 years, the impact is felt earlier (beginning in FY91) and peaks at about $2.0 billion per annum in the late 1990s.

28. The second impact on the Bank's borrowing requirements operates via the liquidity policy. This policy requires the Bank to build up its liquid assets in advance of actual cash outlays. Since the policy objective is guided by cash requirements over a three year period, an additional outlay projected for FY91, for example, will have a slight impact on the target for liquid assets to be held at the end of FY88. The overall impact of the liquidity policy is to draw forward a portion of the direct borrowing requirements into the earlier years. If grace periods are not changed, the impact begins to be felt in FY91 in a very small way (i.e., additional net borrowings of about $100 million). If grace periods are changed, there would be a modest increment to projected borrowing requirements in FY88-FY90, with most of the impact occurring in FY89 (about $350 million) and FY90 (about $550 million). In both cases the borrowing requirements would be modest in relation to the Bank's established borrowing potential, particularly in view of the fact that the build up in incremental requirements would occur very gradually over the next 10 years or so.

29. The effect of the change in repayment terms on risk to the Bank's portfolio will depend on the interaction of two countervailing effects. Most directly, for any lending program, the slower rate of amortization would result in an increase in overall Bank exposure and, hence for any given level of of capital and reserves, increased vulnerability. However, the modified debt service profile may well raise the overall creditworthiness of the country and, by smoothing out the pattern of IBRD net flows and transfers, may reduce the probability of arrears. In particular, debt service to IBRD would be lowered in the early to mid-1990s, when the overall debt service burden is still expected to be severe

and, when under present lending plans and repayment schedules, IBRD net disbursements are expected to fall in many highly indebted countries. In our judgement, this positive impact associated with restructuring the stream of debt service payments to bring it more closely into line with the ability of the country to pay, is likely to more than offset the effects of higher overall exposure.

Annex 1: Comparison of Debt Service Payments Under the Equal Principal
and Level Annuity Repayment Systems
(Loan Amount = 100)

Year	Disbursement (Annual)	Current Terms: Repayment (Annual)	Current Terms: Charges 1/ (Annual)	Current Terms: Total Payments	Current Terms: Disb & Outst (Cumulative)	Annuity Terms: Repayment (Annual)	Annuity Terms: Charges 1/ (Annual)	Annuity Terms: Total Payments	Annuity Terms: Disb & Outst. (Cumulative)	Difference: Repayment (Annual)	Difference: Charges 1/ (Annual)	Difference: Total Payments	Difference: Disb & Outst. (Cumulative)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
1	5	0	1.11	1.11	5.00	0	1.11	1.11	5.00	0	0	0	0
2	20	0	2.56	2.56	25.00	0	2.56	2.56	25.00	0	0	0	0
3	13	0	3.51	3.51	38.00	0	3.51	3.51	38.00	0	0	0	0
4	13	0	4.45	4.45	51.00	0	4.45	4.45	51.00	0	0	0	0
5	14	0	5.46	5.46	65.00	0	5.46	5.46	65.00	0	0	0	0
6	13	6.67	5.87	12.54	71.33	4.89	6.01	10.91	73.11	-1.77	0.14	-1.63	1.77
7	10	6.67	6.06	12.73	74.67	4.53	6.38	10.91	78.58	-2.14	0.31	-1.82	3.91
8	7	6.67	6.04	12.70	75.00	4.37	6.53	10.91	81.20	-2.29	0.50	-1.80	6.20
9	5	6.67	5.87	12.53	73.33	4.36	6.55	10.91	81.85	-2.31	0.68	-1.63	8.51
10		6.67	5.33	12.00	66.67	4.74	6.17	10.91	77.11	-1.93	0.84	-1.09	10.44
11		6.67	4.80	11.47	60.00	5.15	5.76	10.91	71.96	-1.52	0.96	-0.56	11.96
12		6.67	4.27	10.93	53.33	5.60	5.31	10.91	66.36	-1.07	1.04	-0.03	13.03
13		6.67	3.73	10.40	46.67	6.08	4.82	10.91	60.28	-0.58	1.09	0.51	13.61
14		6.67	3.20	9.87	40.00	6.61	4.29	10.91	53.66	-0.06	1.09	1.04	13.66
15		6.67	2.67	9.33	33.33	7.19	3.72	10.91	46.48	0.52	1.06	1.57	13.14
16		6.67	2.13	8.80	26.67	7.81	3.09	10.91	38.66	1.15	0.96	2.11	12.00
17		6.67	1.60	8.27	20.00	8.49	2.41	10.91	30.17	1.83	0.81	2.64	10.17
18		6.67	1.07	7.73	13.33	9.23	1.68	10.91	20.94	2.56	0.61	3.17	7.61
19		6.67	0.53	7.20	6.67	10.03	0.87	10.91	10.91	3.37	0.34	3.71	4.24
20		6.67	0.00	6.67	0.00	10.91	0.00	10.91	0.00	4.24	0.00	4.24	0.00
Total	100	100.00	70.26	170.26	845.00	100.00	80.68	180.68	975.27	0.00	10.42	10.42	130.27
Gross Capital Coefficient 2/					8.45				9.75				

1/ Charges include interest charges and commitment fees.

2/ Capital requirements are calculated as the total amount disbursed and outstanding, assuming a sequence of loans is made and a so-called "steady state" is reached. (This equals the sum of the amounts shown in columns (6) and (10)). It is measured by the gross capital coefficient, or the capital requirements per dollar of loan amount and is affected by both the repayment terms assumed and disbursement schedule. In the case of fast-disbursing loans, the amount disbursed and outstanding in the early years of the loans is higher and the gross capital coefficient will thus be higher than that of a specific investment loan with a longer disbursement period.

Assumption (Current Terms):

Maturity/Grace Period (year) 20/5

Average IBRD Disbursement Profile

Repayment on equal annual bases

Assumption (Annuity Terms):

Maturity/Grace Period (year) 20/5

Average IBRD Disbursement Profile

Principal repaid at an ascending amounts calculated to yield a series of constant total service payments during the repayment period.

Annex 2: Comparison of Debt Service Payments Under Current System
and Level Annuity Repayment System
for Middle Income Countries
With Extended Grace Period
(Loan Amount = 100)

		Current Terms				Annuity Terms with Extended Grace Period				Difference Between Level Annuity with Extended Grace Period and Current System			
Year	Disbursement (Annual)	Repayment (Annual)	Charges (Annual)	Total Payments	Disb & Outst (Cumulative)	Repayments (Annual)	Charges (Annual)	Total Payments	Disb & Outst (Cumulative)	Repayments (Annual)	Charges (Annual)	Total Payments	Disb & Outst. (Cumulative)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
1	5	0	1.11	1.11	5.00	0	1.11	1.11	5.00	0	0	0	0
2	20	0	2.56	2.56	25.00	0	2.56	2.56	25.00	0	0	0	0
3	13	0	3.51	3.51	38.00	0	3.51	3.51	38.00	0	0	0	0
4	13	8.33	3.78	12.11	42.67	0	4.45	4.45	51.00	-8.33	0.67	-7.67	8.33
5	14	8.33	4.13	12.46	48.33	0	5.46	5.46	65.00	-8.33	1.33	-7.00	16.67
6	13	8.33	4.41	12.74	53.00	8.00	5.77	13.76	70.00	-0.34	1.36	1.02	17.00
7	10	8.33	4.46	12.80	54.67	7.90	5.86	13.76	72.10	-0.43	1.39	0.97	17.43
8	7	8.33	4.30	12.64	53.33	8.04	5.72	13.76	71.06	-0.29	1.42	1.12	17.73
9	5	8.33	4.00	12.33	50.00	8.34	5.42	13.76	67.72	0.01	1.42	1.43	17.72
10		8.33	3.33	11.67	41.67	9.07	4.69	13.76	58.65	0.74	1.36	2.10	16.98
11		8.33	2.67	11.00	33.33	9.86	3.90	13.76	48.79	1.53	1.24	2.76	15.45
12		8.33	2.00	10.33	25.00	10.72	3.05	13.76	38.07	2.38	1.05	3.43	13.07
13		8.33	1.33	9.67	16.67	11.65	2.11	13.76	26.42	3.31	0.78	4.10	9.76
14		8.33	0.67	9.00	8.33	12.66	1.10	13.76	13.76	4.33	0.43	4.76	5.43
15		8.33	0.00	8.33	0.00	13.76	0.00	13.76	0.00	5.43	0.00	5.43	0.00
Total	100	100.00	42.26	142.26	495.00	100	54.71	154.71	650.57	0.00	12.45	12.45	155.57
Gross Capital Coefficient					4.95				6.51				

Assumption (Current Terms):

- Maturity/Grace Period (year) 15/3
- Interest Rate: 8.00%
- Commitment Fee: 0.75%
- Average IBRD Disbursement Profile
- Repayment on equal annual bases

Assumption (Annuity terms with extended grace year):

- Maturity/Grace Period (year) 15/5
- Interest Rate: 8.00%
- Commitment Fee: 0.75%
- Average IBRD Disbursement Profile
- Principal repaid at an ascending amount calculated to yield a series of constant total service payments during the repayment period.

Annex 3: Comparison of Debt Service Payments Under Current System
and Level Annuity Repayment System
for Middle Income Countries
(Loan Amount = 100)

		Current Terms				Annuity Terms				Difference Between Level Annuity and Current System			
Year	Disbursement (Annual)	Repayment (Annual)	Charges (Annual)	Total Payments	Disb & Outst (Cumulative)	Repayments (Annual)	Charges (Annual)	Total Payments	Disb & Outst (Cumulative)	Repayments (Annual)	Charges (Annual)	Total Payments	Disb & Outst. (Cumulative)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
1	5	0	1.11	1.11	5.00	0	1.11	1.11	5.00	0	0	0	0
2	20	0	2.56	2.56	25.00	0	2.56	2.56	25.00	0	0	0	0
3	13	0	3.51	3.51	38.00	0	3.51	3.51	38.00	0	0	0	0
4	13	8.33	3.78	12.11	42.67	7.79	3.82	11.62	43.21	-0.54	0.04	-0.50	0.54
5	14	8.33	4.13	12.46	48.33	7.37	4.25	11.62	49.84	-0.97	0.12	-0.85	1.51
6	13	8.33	4.41	12.74	53.00	6.98	4.63	11.62	55.85	-1.35	0.23	-1.12	2.85
7	10	8.33	4.46	12.80	54.67	6.80	4.81	11.62	59.05	-1.53	0.35	-1.18	4.38
8	7	8.33	4.30	12.64	53.33	6.84	4.77	11.62	59.21	-1.49	0.47	-1.02	5.88
9	5	8.33	4.00	12.33	50.00	7.04	4.57	11.62	57.16	-1.29	0.57	-0.72	7.16
10		8.33	3.33	11.67	41.67	7.66	3.96	11.62	49.51	-0.68	0.63	-0.05	7.84
11		8.33	2.67	11.00	33.33	8.32	3.29	11.62	41.18	-0.01	0.63	0.62	7.85
12		8.33	2.00	10.33	25.00	9.05	2.57	11.62	32.14	0.71	0.57	1.28	7.14
13		8.33	1.33	9.67	16.67	9.83	1.78	11.62	22.31	1.50	0.45	1.95	5.64
14		8.33	0.67	9.00	8.33	10.69	0.93	11.62	11.62	2.35	0.26	2.62	3.28
15		8.33	0.00	8.33	0.00	11.62	0.00	11.62	0.00	3.28	0.00	3.28	0.00
Total	100	100.00	42.26	142.26	495.00	100	46.59	146.59	549.08	0.00	4.33	4.33	54.08
Gross Capital Coefficient					4.95				5.49				

Assumption (Current Terms):

Maturity/Grace Period (year)	15/3
Interest Rate:	8.00%
Commitment Fee:	0.75%

Average IBRD Disbursement Profile
Repayment on equal annual bases

Assumption (Annuity terms with unchanged grace periods):

Maturity/Grace Period (year)	15/3
Interest Rate:	8.00%
Commitment Fee:	0.75%

Average IBRD Disbursement Profile
Principal repaid at an ascending amount calculated to yield a series of constant total service payments during the repayment period.

ANNEX 4

Average Loan Life under
Alternative Repayment Terms

	Maturities			Bank
	15 years	17 years	20 years	Average
Current terms	4.85	6.35	8.34	6.90
Level annuity to low income borrowers	4.85	6.35	9.45	7.40
Level Annuity with current grace periods for all borrowers	5.23	7.01	9.45	7.65
Level Annuity with 5 year grace period for all borrowers	6.32	7.55	9.45	8.10
Level Annuity to low income borrowers and 5 years grace periods with equal principal repayments to all others	5.87	6.86	9.45	7.83

① MH

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDANCE DATE : 87/12/07 DUE DATE : 00/00/00
LOG NUMBER : 871209004 FROM : Moeen Qureshi
SUBJECT : Gabon

OFFICE ASSIGNED TO FOR ACTION : ② Mr. B. Conable (E-1227)

ACTION:

______	APPROVED
______	PLEASE HANDLE
✓	FOR YOUR INFORMATION
______	FOR YOUR REVIEW AND RECOMMENDATION
______	FOR THE FILES
______	PLEASE DISCUSS WITH ______
______	PLEASE PREPARE RESPONSE FOR ______ SIGNATURE
______	AS WE DISCUSSED
______	RETURN TO CP-file

COMMENTS :

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 7, 1987

TO: Mr. Barber B. Conable

FROM: Moeen A. Qureshi

EXTENSION: 73665

SUBJECT: Gabon

This is just to record the gist of my conversation with you concerning Gabon.

I indicated to you that I had no problems with the loan conditionality and the proposed policy matrix to be developed along the lines stated in your note to me, but I did have a problem with the loan size. I requested that I have the flexibility to go up to $50 million, in order to have adequate leverage, taking into account the size of the country and the problems it faced, to negotiate with the Government of Gabon the kind of policy reforms that we wanted.

You said that your desire was that our lending be the minimum that was necessary to achieve our objectives in Gabon, and that you would be prepared to go along with an SAL of up to $50 million if I felt that was necessary.

Finally, I said that, for the time being, except for the proposed SAL, we would do no further work in Gabon on any additional projects until it became quite clear that the negotiations on the reform program and the first tranche release had proceeded satisfactorily. This would give you time to review performance and then decide on the size and composition of the FY89-90 Lending Program for Gabon.

cc: Mr. Jaycox
Mr. Serageldin

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 23, 1987

TO: Members of the Policy Committee

FROM: Moeen A. Qureshi

EXTENSION: 73665

SUBJECT: GABON - Size of Proposed SAL

1. An issue was raised at the Policy Committee on November 18 whether a loan of $50 million was excessive for a country with a one million population. Since the issue has general implications for Bank lending, I wish to clarify the position we took with respect to the loan.

2. The loan to Gabon certainly implies a rather high level of lending on a per capita basis to the country. However, as the attached Tables 1 and 2 show, it is not an excessive per capita level of lending compared to loans provided in the past for some other small countries.

3. However, quite apart from the issue of comparability, it does not seem to me meaningful or even relevant to judge the size of an IBRD loan by the size of the population. Even in IDA where, in my view, population size is a more relevant consideration, we have drifted away from any clear linkage by allocating proportionately much more to Africa, Bolivia and the various island economies than to comparable Asian countries. The economic size of the country is a more relvant yardstick for measuring capital requirements, and that is better defined in relation to national income and related aggregates such as savings, investments, exports and imports rather than population size. Capital needs in particular are closely linked to income. It is not possible to sustain a high level of income without a large capital stock. As is evident from Table 3, when the Gabon SAL is viewed in relation to the country's GDP and its investment and imports, it is well within the limits of Bank practice.

4. This factor is further enhanced in countries that are small in geographical size as Gabon, are more trade dependent, and require relatively higher capital inflows to sustain growth when trade gaps open up. Gabon's projected annual gross external financing requirements amount to about $850 million during 1987-89, similar to those projected for Ecuador or Bolivia during 1988-92, i.e., countries in which the proposed Bank FY88-90 lending programs are substantially higher, amounting to $175 million and $70 million, respectively.

SRajapatirana/UThumm:eg:vls

Table 1

FY83 - 87 SELECTED ADJUSTMENT OPERATIONS (11/19/87)
(RANKED BY $ PER CAPITA COMMITMENTS)

COUNTRY	1986 POPULATION (MIL.)	1986 PER/CAP GNP ($)	NAME	FY	AMOUNT ($ MIL.)	AMOUNT ($ PER CAP.)
PANAMA	2.222	2170	SAL II-A	87	100.0	45.0
MAURITIUS	1.032	1200	STR. ADJ. II	84	40.0	38.8
DOMINICA	.079	1210	SAC I-A	87	3.0	38.0
SAO TOME & P	.111	340	SAL	87	4.0	36.0
COSTA RICA	2.660	1380	SAL I (AP 5.0)-A	85	80.0	30.1
PANAMA	2.222	2170	SAL I (AP)	84	60.2	27.1
JA[illegible]A	2.261	860	STRUCTURAL ADJUSTMENT II	83	60.2	26.6
U[illegible]	3.034	1710	STRUC ADJ I-A	87	80.0	26.4
JA[illegible]A	2.261	860	STRUCTURAL ADJUSTMENT III	85	55.0	24.3
MAURITIUS	1.032	1200	INDUS. SAL	87	25.0	24.2

40.

Table 2

FY85 - 87 LENDING PROGRAMS (11/19/87)

COUNTRY	1986 POPULATION (MIL.)	1986 GNP/CAP. ($)	FY85-87 COMMIT. ($MIL.)	FY85-87 COMMIT. ($PCPA)
SAO TOME & P	.111	340	16.9	50.8
DOMINICA	.079	1210	6.0	25.3
OMAN	1.288	5000	80.1	20.7
BARBADOS	.255	4980	14.0	18.3
EQUATORIAL G	.381	230	20.4	17.8
MAURITIUS	1.032	1200	55.0	17.8
GRENADA	.098	1240	5.0	17.0
BELIZE	.159	1200	7.5	15.7
GABON	1.0	3074	70.0 1/	35.0 1/

1/ FY88-89

Table 3

Country	FY	Adjustment Operation	Commitment Amount ($ Mil.)	Commitment Amount as % of 1985 GDP	1985 Gross Domestic Investment	1985 Merchandise Imports
Argentina	87	Trade Policy	500.0	0.8	8.4	13.1
Bolivia	86	Reconst. Import Cr.	55.0	1.8	10.8	10.0
Costa Rica	85	SAL I	80.0	2.1	9.1	7.2
Ecuador	86	Agric. Sector	100.0	0.8	4.4	6.2
Morocco	86	Ind. Trade Pol. Adj.	200.0	1.7	7.8	5.1
Colombia	85	Trade Policy	300.0	0.9	4.8	7.3
Jamaica	85	SAL III	55.0	2.8	12.1	4.9
Nigeria	87	Trade Policy/Exp.	452.0	0.6	6.0	5.1
Gabon	88	SAL	50.0	1.4	3.9	4.7

S.Mannan:eg
11/23/87

The World Bank
OPERATIONS COMMITTEE

Minutes of the Operations Committee to Consider
Gabon - Country Strategy Paper cum Initiating
Memorandum for a Proposed Structural Adjustment Loan

Held on November 6, 1987 in Conference Room E-1244

A. Present

Committee	Others
Messrs. M. Qureshi	Messrs. I. Serageldin (AFR)
E. Jaycox (AFRVP)	R. Skillings (AF1)
A. Karaosmanoglu (ASIVP)	P. Alba (AF1)
V. Rajagopalan (VPPRE)	F. Vakil (AF1)
W. Thalwitz (EMNVP)	T. Baudon (SVPOP)
J. Wood (FPBVP)	A. Steer (FRS)
C. Quijano (LACVP)	V. Dubey (EAS)
H. Scott (VPL)	U. Thumm (EAS)
	R. Harris (COD)
	F. Earwaker (SPR)
	Ms. C. Morin (LEG)

B. Issues

1. The meeting was called on the Country Strategy Paper cum Initiating Memorandum for a Structural Adjustment Loan to Gabon in the amount of $35 million. The discussions mostly followed the agenda prepared by the Economic Advisory Staff. The issues raised were (a) IBRD eligibility and size of lending program, (b) government commitment and timing of adjustment program, (c) trade policy, (d) sector policies, and (e) government expenditures.

C. The Discussion

IBRD Eligibility and Size of Lending Program

2. The Region made an opening statement on Bank-country relations and recent economic developments in Gabon. It was pointed out that the sharp drop in oil prices resulted in a steep decline of Gabon's GDP and financial difficulties. In response to the crisis, Gabon's external debt was rescheduled and an IMF standby arrangement was put in place. Moreover, the government asked for Bank support which was agreed in principle in Mr. Conable's meeting with President Bongo. The Region also reported on new oil contracts and gave an overview of the ongoing adjustment program which was considered so important as to open a window of opportunity for major structural changes during the next three to four years thus constituting the basis for the proposed SAL and other lending activities.

3. Questions were raised regarding the lending program and continued government commitment to adjustment in light of improved oil prospects and access to commercial bank lending. The Region stressed that the whole lending

program would be conditioned on the successful completion of the SAL and that manpower allocations to other lending operations would be managed cautiously. The Region also emphasized the need for broader Bank involvement to stimulate supply responses in different sectors. It felt strongly that the preparation of additional operations should be left to Regional Management's judgment. Regarding Gabon's future GDP per capita and IBRD eligibility, the Region stood by its projections which showed future per-capita GDP to be below the graduation level while at the same time suggesting continued creditworthiness.

Timing of Adjustment Program

4. While agreeing in principle that the SAL should be frontloaded to the extent possible to maximize government commitment, the Region particularly mentioned how complex and difficult it was to set up the proposed oil fund and to establish meaningful operating rules. In this context, the question was also raised whether the Bank had a new general policy of recommending stabilization funds. The Chairman replied that there was no general policy but that in countries with strong dependence on one commodity a prima facie case could be made for the establishment of some stabilization mechanism. The design and operation could obviously vary from country to country.

5. Regarding the proposed Technical Assistance project, the Region mentioned that a UNDP financed project is currently underway, with the Bank acting as executing agency, and that therefore no additional support was needed for several years.

Trade Policy

6. Regarding the anti-export bias created by high tariffs, the Region stressed that its first priority was to eliminate QRs and to provide free-trade status for exports. The Region also pointed out that most exports would be resource based and that therefore tariffs for manufactured products were less important for the overall incentives structure. The Region was asked to focus essentially on the adequacy of incentives for exports and on the stimulation of supply responses in different sectors through direct promotion measures.

Sector Policies

7. There was general agreement as to the importance of good sector policies for adequate supply responses, and the Region promised to try hard to get the government to prepare policy statements for key sectors as soon as possible. At the same time, a speaker cautioned against too high expectations regarding the development of different sectors outside oil and timber.

Government Expenditures

8. There was general agreement that limiting government spending to high priority activities was crucial for the success of Gabon's adjustment process. The Region agreed to condition the release of the second tranche on the satisfactory implementation of the three-year investment program to be agreed with the government and its extension on a rolling basis.

Decisions

9. Subject to minor modifications as recorded, the Region was authorized to go ahead with the preparation of the proposed SAL. The loan amount was increased to $50 million as requested by the Region.

10. The Chairman decided that the CSP cum IM should also be reviewed by the Policy Committee.

November 10, 1987

UThumm:vlw

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 27, 1987

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXT: 78051

SUBJECT: GABON - CSP cum Initiating Memorandum for a Proposed $35 million SAL - Agenda

1. The Operations Committee will meet on November 6, 1987 at 4:00 p.m., in Room E-1244 to discuss the Country Strategy Paper cum Initiating Memorandum (CSP-IM) for Gabon. The proposed strategy is in line with Mr. Conable's commitment to President Bongo on August 5, 1987, i.e., to resume Bank lending to Gabon provided agreement is reached on an adjustment program to be supported by a SAL which would help to enhance Gabon's creditworthiness over the medium term.

Country Strategy

2. The Region proposes a FY88-92 lending program of $158 million for seven operations of which the first would be the proposed FY88 $35 million SAL. The proposed strategy aims at (i) the diversification of the Gabonese economy to make it less dependent on oil exports, through a structural adjustment program; (ii) the consolidation of the stabilization process that was initiated with IMF support in 1986; and (iii) the enhancement of Gabon's creditworthiness. The diversification of the economy would be pursued through specific adjustment measures which would change relative prices in favor of non-oil tradeables and through investments in agriculture, human resources, and export-related infrastructure which would be partly supported by proposed Bank loans, beginning with the SAL I.

3. The proposed strategy seems to address Gabon's development issues and needs adequately. However, since the whole country strategy hinges on the adjustment program and the successful negotiation of the SAL, issues to be raised in the context of the SAL also have a bearing on the proposed lending program. The Committee may wish to consider limiting the preparation of proposed lending operations to those programmed for FY88 and 89 while the rest of the five-year lending program could be reviewed at the time the decision on the release of the second tranche of the proposed SAL would come up.

Proposed $35 million SAL

4. The overwhelming weight of the oil sector in the Gabonese economy has resulted in grave distortions which have created an almost complete dependence on oil revenues and rendered the non-oil economy internationally non-competitive. Major stabilization and adjustment measures for a prolonged period of time are required to correct the misguided development of the past. The Region spells out the political risks associated with the adjustment process and with a possible recovery of oil prices, and leaves

considerable doubts regarding the government's sustained commitment to the adjustment program. It is against this background that the Committee may wish to raise the following issues:

(a) in the absence of nominal exchange rate flexibility, fiscal, monetary, and income policies become the key instruments to affect the real exchange rate. The question arises whether key measures such as (i) the establishment of the oil reserve fund; (ii) the introduction of a generalized tariff/export subsidy scheme; and (iii) the lowering of wages (lower urban minimum wage; even lower rural minimum wage; and abolition of minimum wage for small enterprises) should not be made conditions of Board presentation (rather than second tranche conditions) to get full government commitment;

(b) given the importance of aggregate demand management, the Region could be asked to consider whether the concept of the oil reserve fund could not also be extended to other commodities (e.g., cocoa, coffee, and timber); and

(c) to help the government manage the adjustment process, the Region could be asked to explore the feasibility of advancing the proposed technical assistance project as a direct complement to the proposed SAL.

5. Although replacing QRs by tariffs and lowering tariffs from current levels will be important steps to stimulate non-oil exports, the question arises whether an ultimate tariff level of 80 percent (120 percent for "luxury goods") as proposed by the Region does not create too great an export bias and/or cost disadvantage and render domestic activities internationally uncompetitive. The Region could be asked to look into the feasibility of free-trade status for export activities. Moreover, domestic excise taxes for "luxury goods" could be considered instead of differentiated tariffs.

6. The supply response in agriculture, forestry, mining, and fisheries is uncertain, and Bank knowledge of the sectors is limited. Government development strategy statement for some of the sectors are envisaged for the future. The Region could be asked to seek such Government strategy statements in time for the release of the second tranche, possibly together with an overall and sector-specific programs of action for the next 12-18 months.

7. The level and structure of public investment is crucial for demand management and future socio-economic development. The condition of Board presentation would have to be a fully satisfactory three-year program as reflected in the 1988 Loi Programme. As condition for the second tranche release, the Region could be asked to add the satisfactory implementation of the program and extension of the program into the future on a rolling basis.

8. The external financing plan as presented in the balance of payments and central government financial projections is not fully

transparent, and the projections of private capital flows are perhaps somewhat optimistic (assuming, inter alia, that the foreign oil sector's engagement in Gabon would continuously rise). The country's future creditworthiness hinges on the materialization of very high capital flows and the closing of an additional gap of $390 million (presumably through additional debt rescheduling beyond 1988). Could the region present a clearer financing plan for the entire public sector and discuss alternative scenarios of meeting/adjusting the requirements?

9. The social impact of the proposed adjustment program is well described, with actually little room for mitigation as the overall drop in per-capita GDP is projected to amount to at least 35 percent between 1985 and 1995. Could the Region elaborate on possible government action and their fiscal feasibility?

cc: Messrs. Lee, COD; Shakow, Liebenthal, SPR; Holsen, CEC; Rao, Steer, FRS; Baneth, IEC; Thahane/Burmester, SEC; Bock, DFA; Baudon, SVPOP; Frank, Parmar, IFC; Serageldin, Landell-Mills, Fares, Alba, AFR; Ms. Haug, EXC.

UThumm:vlw

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 13, 1987

TO: Mr. Moeen A. Qureshi, SVPOP

THROUGH: Mr. Sven Sandstrom, Acting AFRVP

FROM: Ismail Serageldin, AF1DR

EXTENSION: 34502

SUBJECT: GABON - Country Strategy Paper

1. I enclose herewith for your clearance the Country Strategy Paper (CSP) for Gabon. Please note that this document is also to serve as the Initiating Memorandum for the proposed SAL operation. The comments received at the RVP review meeting have been incorporated in the present version.

2. As you are aware, Mr. Conable informed President Bongo at a meeting held on August 5, 1987, that the Bank would be willing to resume lending to Gabon, provided the first operation is a SAL which would establish Gabon's creditworthiness. He promised that a mission would visit Gabon in October to continue preparations of the SAL. The Board was subsequently informed of Senior Management's decision to resume lending to Gabon.

3. Earlier in the year, an IBRD technical assistance mission helped the Government prepare a draft Statement of Development Policy. The main objective of the Government's adjustment program is to achieve a broad restructuring of the economy by reducing its dependence on oil and by reorienting activities towards the productive sectors. A significant measure included in the program is the general reduction in wage levels throughout the economy. This would indirectly realign the real exchange rate, and thus improve the competitiveness of the non-oil productive sectors. Other measures envisaged include trade liberalization, export subsidies, planning and budgeting improvements, public enterprise reform, liberalization of agriculture and forestry marketing, and labor market reforms.

4. The program has been extensively discussed at the technical level in Gabon, but has not yet been formally adopted at the political level. Indications are that the Government has a strong interest in reaching agreement with the Bank. The difficult issues are likely to be:

(a) The extent to which capital spending and nominal wages of civil servants are reduced in the context of a stabilization package with the IMF;

(b) The speed of the liberalization process, including the ultimate abolition of the Société Nationale du Bois Gabonaise (SNBG), the reform of labor legislation, the elimination of quantitative restrictions on goods, and the reduction and ultimate abolition of marketing activities of the coffee and cocoa marketing boards; and

(c) the establishment of a petroleum reserve fund to promote productive activities and dampen the boom/bust cycles associated with the fluctuations in oil prices.

5. We would plan to examine these issues with the Government during the forthcoming pre-appraisal mission. In the first SAL, we cannot expect to reach full agreement on all the measures in the policy matrix, but hope to arrive at a satisfactory understanding on the broad policy directions and to agree on the first steps towards their implemention.

6. The major risk associated with the resumption of Bank lending to Gabon is political. The domestic consensus now established in favor of structural adjustment could unravel if certain influential elements in the Government became persuaded that they can cover the present revenue shortfall by commercial borrowing, should oil revenues return to earlier levels. However, since the recent new oil find cannot be brought into production before the mid 1990s, we expect to be able to convince the Government of the need for structural adjustment and to establish the discipline of managing oil revenues judiciously. A serious government commitment to the proposed petroleum reserve fund would go a long way towards minimizing the long-term risks associated with the program.

7. Next actions. A pre-appraisal mission is scheduled for October 12-31, 1987; assuming sufficient agreement on the difficult issues noted above, an appraisal mission is planned for December 5-20, 1987, and negotiations are set for January 25-28, 1988. Board presentation is targeted for March 29, 1988. In light of the tight schedule, we would appreciate if the Operations Committee review meeting were scheduled as soon as possible.

cc: Messrs. Jaycox (o/r), O'Brien (AFRVP), Dubey, Thumm (EAS), Singh (AF1DR), Landell-Mills, Westebbe, Fares, Vakil, Alba (AF1CO), Ms. Jourdan (AF1CO), AF1 Division Chiefs.

PAlba/NASherbiny/FVakil:cp

COUNTRY STRATEGY PAPER

GABON

Conclusions and Recommendations

(i) Gabon is facing a serious economic and financial crisis brought about by the recent collapse in oil prices. Even before its independence in 1960, Gabon has been an enclave economy. Exports of minerals then oil permitted the economy to be transformed from subsistence agriculture to heavy dependence on non-tradeable activities. This trend was accentuated as oil revenues increased in importance in the Government budget. In early 1986, realizing that resources could no longer match commitments, the Government requested assistance from the Bank and the IMF. The Fund, with Bank support, developed a 25-month standby program, which was approved in December 1986. Agreements to reschedule September 1986-end 87 debt service with the Paris Club as well as principal falling due between September 1986 and end 1988 with the London Club have been concluded. With these measures behind, the Government is now turning its full attention to defining its medium-term structural adjustment program.

(ii) Gabon graduated from Bank lending in 1977. With the 1986 sharp decline in oil prices, per capita GNP has fallen to a level justifying the resumption of lending, and is expected to remain eligible well into the next decade. As indicated by Mr. Conable to President Bongo at a meeting in August 1987, to help Gabon overcome its crisis, we are proposing to resume lending with a US$35 million SAL, provided agreement can be reached on a credible adjustment program. So far, the Government has reacted positively to the need for complementing its noteworthy stabilization efforts with a set of more far reaching measures that address the underlying structural issues.

(iii) Our proposed strategy is two-fold. First, working in conjunction with the IMF we are helping the Government develop a stabilization package involving the sharp cuts in aggregate demand (especially nominal wages and capital spending) needed in the face of reduced oil resources. Second, building on these cuts, we are assisting the Government to elaborate a structural adjustment program which aims at reversing the trend of the last two to three decades towards greater enclave/petroleum sector dependency. This will imply a major shift in resources from non-tradeables toward the productive tradeable sectors, principally (but not solely) agriculture.

(iv) The SAL policy package will aim at indirectly correcting the overvaluation of Gabon's currency, so as to increase the international competitiveness of its non-oil economy. A closely related effort will be to reduce the high level of salaries through reducing the nominal wage structure and the attraction of the public sector as a source of employment. Furthermore, economic liberalization would introduce greater competition, and thereby not only improve resource allocation but also reduce domestic cost structures. A necessary complement to these efforts will be a well developed investment program in agriculture, transport,

small- and medium-scale enterprises, and utlimately, education. In addition, we will seek to persuade the Government to establish a petroleum reserve fund to promote productive activities, instead of increasing civil-service salaries or expanding inappropriate infrastructure projects.

(vi) Under the present base case scenario, Gabon's creditworthiness should be easily sustained: as rescheduled, the 1987 debt-service ratio is 7.0 percent of export revenue. This is projected to rise to 26.0 percent by 1989, possibly requiring further rescheduling. Nevertheless, the base-case results demonstrate that Gabon can meet its debt-service obligations including those of the Bank. Probably the major risk associated with the Bank's resumption of lending to Gabon is less one of financial exposure than one of overall failure of the restructuring strategy should oil revenues return soon to earlier levels. Under such circumstances, political pressures might induce the Government to do away with the discipline of a SAL program. It might be politically difficult for the Government to avoid re-launching ill-conceived public works programs, particularly those which have been halted in mid-course, or to restore public and parastatal sector salaries to their former levels. The proposed petroleum reserve fund that dampens boom/bust cycles and the leverage provided by our lending program and policy dialogue will help guard against this risk.

(vii) Consistent with the above, we propose a combination of fast disbursing loans and a lending program which focusses on the needs of developing the rural infrastructure long neglected in Gabon. Thus we foresee the need for a lending program of about US$150 million for FY88-91, of which approximately half would be for two fast-disbursing SALs. Other operations would be in agriculture (foodcrop marketing and research, nucleus estates); transport (road rehabilitation and maintenance); small and medium-scale enterprise and technical assistance. Our ESW would be oriented towards the refinement of our medium-term framework, the improvement in our sector knowledge in agriculture, transport, and education, and the support of our aid coordination effort.

(viii) Gabon's risk rating has not been re-assessed since 1978. However, assuming that our base case assumptions hold, we believe that Bank intervention through structural adjustment and renewed project lending -- together with improved coordination with other lenders -- will be instrumental in strengthening economic management to the point where full creditworthiness could be re-established. While the proposed program is large in per-capita terms, it is justified because financial exposure is not high and the Government has demonstrated its will to embark on a lasting process of restructuring. Moreover, with other donors already in line to support the adjustment process, the burden will be shared and Bank exposure will remain limited. While there are risks, these seem manageable. Most prominent are those associated with wide fluctuation in oil prices which could unravel the political consensus now established in favor of adjustment. The order of priority in our dialogue should thus be to convince the government of the need to continue the discipline. Given the progress to date and the relatively low risk level, we recommend a resumption of lending with the proposed SAL as the first operation.

II. BACKGROUND

1. Gabon, a country of about one million people, has long been prosperous by African standards. This prosperity is a reflection of its comfortable resource position, which includes ample arable land relative to its population, good climatic conditions, a substantial stock of largely unexploited forestry resources, large mineral deposits including uranium and manganese as well as iron ore (not currently mined), and oil. The latter, whose production first began in 1957, has assumed increasing importance in Gabon's total GDP, and dominated exports, particularly since 1974. With the exception of agriculture and forestry, however, export activities have been heavily enclave in nature, providing the country with wealth but little self-sustaining economic development. By 1985, Gabon's per capita GNP had reached US$3,400, 45 percent of which was accounted for by petroleum. In the same year, value-added in the non-tradeable sectors of the remainder of the economy -- heavily dependent upon the expenditure of oil revenues -- reached 70 percent of non-oil GDP.

2. While there are few constraints on arable land, domestic food production is increasingly being supplemented by imports as urban consumers have gradually turned away from traditional crops such as cassava, plantains, maize and taro to animal proteins and grains. As a result, total imports of foodstuffs have grown over 15 percent per annum during the past decade. Traditional staples continue to represent the bulk of the rural diet and a non-negligible part of the urban diet. These staples are produced under generally primitive conditions of slash and burn cultivation with few inputs or improved strains, difficult internal marketing conditions and little institutional support. Development of the enclave sectors reduced the relative contribution of agriculture from 14 percent of non-oil GDP in 1966 to 7.5 percent in 1973, where it stayed through 1985. Export agriculture accounted for CFAF 3.3 billion in 1985, or only about 2 percent of total non-oil exports and only 4 percent of total agricultural output.

3. As with agriculture, forestry is a resource with considerable unrealized potential. Forests cover some 20 million ha, about 85 percent of Gabon's territory, with 13 million ha considered productive. Okoumé, a tropical hardwood, accounts for 75 percent of annual log production and exports. There are 40 other species with commercial potential in Gabon. Although the easily accessible coastal zone has been over-exploited, estimates suggest that, with the opening of the interior via the Transgabon Railway, timber production could be substantially increased over the current annual rate of 1.3 million m^3 without erosion of the capital stock or environmental damage. Since the 1960s, log production has declined from an average of 2.2 million m^3, and the share of forestry in non-oil GDP has since fallen from 7 percent of to 1.4 percent in 1985. In that year wood and wood products accounted for 37 percent of non-oil exports, of which 15 percent was processed wood, which could become an increasingly important source of output.

4. In the mining sector, Gabon has the largest known manganese deposits outside of the Soviet Union. However, with the decline in world

steel production and the reduction in manganese requirements per ton of steel, Gabon will not be able to expand exports rapidly over today's level of 2 million tons per annum (37 percent of non-oil exports). The prospects are worse for uranium, (18 percent of non-oil exports) whose exports have stagnated in volume terms at roughly one thousand tons per annum. Having fallen to 6 percent of non-oil GDP in 1985, mining is thus unlikely to give much forward impetus to the non-oil economy in the medium-term for reasons of limited demand and production constraints.

5. The resource-based economy represents by far the bulk of tradeables output. Output of other tradeable goods, such as cement, textiles, beverages and wood processing amounts to less than 5 percent of non-oil GDP in Gabon. In the non-tradeables sector of the economy, construction and public works, together with public administration, rose only slightly from about 20 percent of non-oil GDP in 1966 to 22 percent in 1973; however, it had risen to 31 percent by 1984.

6. The civil service is the mainstay of formal sector employment. Reflecting the Government's policy of distributing the oil rent, salaries are high and public employment excessive. Thus, the per capita cost of the Gabonese civil service has been more than twice that of Cameroon, also an oil exporting country.

Table 1: Comparative Figures on Civil Service Employment, 1985

	Gabon	Cameroon	Congo
Civil Service Employment	27,878	135,117	55,000
Civil Service/ 1000 pop.	27.9	14.3	30.6
Total Wage Bill (bil. CFAF)	107	202	67
Av. Wage (mil. CFAF/employee)	3.84	1.50	1.22

7. Economic Growth. During the 1973 to 1985 oil boom period, growth of the non-oil economy was considerably lower than that in the "pre-oil" period. Despite the sharp growth in construction and public administration financed from oil revenues, growth of non-oil GDP in the later period was 4.2 percent per annum as opposed to an 8.7 percent per annum for earlier years when oil revenues played a less important role. Part of this decline is due to the relative stagnation of non-petroleum exports. However, a good deal of the difference may be attributed to the distortionary effects of the oil boom itself, both as relatively less productive non-tradeables absorbed resources from the generally more productive tradeables sector, and as wage and salary increases over the period came at the expense of profits and smallholder incomes.

8. By 1985, oil revenues permitted the financing of non-oil gross domestic investments amounting to over 40 percent of non-oil GDP. Such investment levels put an enormous strain on Gabon's absorptive capacity, one of effects of which was to lower the marginal productivity of investments. Another was to encourage the continuing growth of wages and

salaries from their already relatively high levels, with minimum wages being permitted to attain two to three times their levels in neighboring countries and salaries for higher skill categories generally were close to, and sometimes exceeded, European levels. By 1979 wages and salaries had risen to 50 percent of non-oil GDP compared to an average of about 30 percent for other African economies such as Togo, Cameroon (non-oil) and the Côte d'Ivoire, implying that equivalently less was available for profits, depreciation and smallholder incomes.

9. The drop in oil prices from US$28.50 a barrel in 1984 to US$12.50 in 1986 led to a decline in exports from US$1.7 billion to US$0.7 billion in this period. This in turn brought the current account deficit to 30 percent of GDP in 1986. It is, however, expected to improve to 15 percent of GDP in 1987, in large part because of a sharp drop in imports and because of a rescheduling of interest payments. Gross national income will be similarly affected, and is expected to fall by 48 percent between 1985 and 1987; non-oil GDP, badly affected by sharp public expenditure cuts, will have fallen by 32 percent over the same period. The oil price collapse also brought government oil revenues from CFAF 400 billion in 1985 to CFAF 70 billion in 1987, a decline of 82.5 percent. The fall in total revenues will be 60 percent.

10. The Gabonese authorities reacted quickly to the deterioration in budgetary revenues and the balance of payments and put in place a stabilization program in mid-1986 with IMF support through the medium of a 25-month standby approved by the IMF Board in December 1986. As a result, Gabon benefitted from substantial debt relief from the Paris and London Clubs. At the request of the authorities, Bank staff assisted during the formulation of the program in reviewing the public investment program and preparing a reform package for the parapublic sector. Although waivers were granted with respect to accumulation of arrears and net credit to Government at end March 1987, the program remains on track. According to the latest information, the performance criteria at end June were observed.

11. As Table 2 indicates, the fall in Government revenues should lead to an 80 percent cut in public capital expenditures between 1985 and 1987. This in turn will induce a reduction in the production of non-tradeables and should thereby represent a major first step to a real correction of the exchange rate, assuming that the real wages of the unemployed factors (labor) are allowed to fall. Under a stand-by program with the Fund (prepared with Bank participation), civil service wages will also be cut by approximately 17 percent in <u>nominal</u> terms (over 20 percent in real terms) from CFAF 115 billion in 1986 to CFAF 95 billion in 1988. A real burden on Gabon's public finances -- and its ability to service foreign and domestic debt -- has been the heavy accumulation of arrears (totalling CFAF 105 billion by the end of 1986) arising largely as a result of extra-budgetary expenditures. However, with the estimated CFAF 96 billion proceeds of the

1987 Paris and London Clubs 1/ debt reschedulings, Gabon will be able to expunge these arrears in accordance with the IMF stand-by program.

Table 2: Central Government Financial Operations, 1984-87
(CFAF Billions)

	Actual			Est.
	1984	1985	1986	1987
Total Revenues	587	632	503	258
Oil	385	400	285	70
Other	203	232	218	188
Total Expenditures	653	715	669	352
Current Expenditures	241	261	276	243
Wages & Salaries	93	107	115	106
Materials & Supplies	80	83	97	68
Transfers, Subsidies and scheduled interest payments	68	71	74	72
Capital Expenditures	412	454	393	106
Budgeted	339	404	298	92
Extrabudgetary & other lending	72	50	95	14
Change in Arrears (decrease: -)	19	10	58	-105
Overall Deficit (cash)	-46	-73	-108	-199
(As a % of GDP)	-4.2	-5.0	-14.4	-9.4

12. The Political Context. The political dimension of the Government budget cannot be ignored. The proposed SAL will have an important component

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1/ Paris Club terms provide effectively for a 100 percent rescheduling of principal and interest from September 21, 1986 through end-December 1987. Reimbursements, to be made in twelve equal payments, are to begin after November 15, 1991, with the last payment to be made by May 15, 1997. In early June commercial bank creditors agreed in principle to reschedule 100 percent of all principal payments falling due between the September date and end-1988, with four years' grace, at 1 3/8 percent over the referent market interest rate.

for strengthening planning and budgeting. In addition, a significant Bank presence, including strong conditionality, will be required if the now heavily politicized character of the investment process is to be contained.

13. On this and other elements of the proposed SAL there is substantial willingness on the part of the Government, and most particularly the now strengthened Ministry of Plan, to introduce major reforms. To some extent these are being implemented as a part of the IMF standby; they reflect the Government's understanding that they have indeed been living beyond their means. Similarly, the Government recognizes that its planning system has been inadequate and is anxious to strengthen it: as a first step a three-year rolling plan will be introduced in September 1987. Reforms of the trade and investment incentive regimes involving the liberalization of the former and a restructuring of the latter are also likely to be accepted, but will probably take more time to implement.

14. The Gabonese authorities feel the Bank's presence to be particularly important, perhaps not so much for the additional resources it will bring as for the implicit seal of approval associated with the resumption of lending. This calls for considerable up-front conditionality. On the other hand, should oil price declines be substantially reversed in the short-run, some degree of retrograde action is likely. The reforms addressed in the structural adjustment program worked out with Bank technical assistance may thus be somewhat weakened. In any event, as President Bongo made clear to Mr. Conable at a recent meeting, the Government is anxious to have the Bank resume operations in Gabon, and is willing to go to some lengths to see this through.

III. Central Development Issues

The Major Sectors

15. Agriculture. Agricultural development has been particularly constrained by "natural" outmigration and the wide dispersion of the population in thinly populated rural areas, which is aggravated by the high cost of maintaining a road infrastructure under heavy rainfall. Moreover, institutional development -- particularly with respect to research and extension -- has been seriously neglected, with no more than 3-4 percent of the current and capital investment budget being devoted to agriculture between 1980-86. In addition, agricultural activities have been undermined by rural wages rising along with urban wages to over US$200/mo. and with heavy demand for construction labor for infrastructure projects drawing farmers from the land and driving up agricultural project costs sharply. Despite relatively favorable producer prices, coffee and cocoa production have fallen sharply from already low levels. The implications of this are that without a well-established agricultural tradition in Gabon, there may well be limited employment possibilities for the average urban worker in the rural sector, even if potential factor mobility is encouraged by sharp reductions in expenditures cn non-tradeables. In contrast with many African countries, Gabon has been fortunate in having relatively few directly abusive or dirigiste practices crippling agriculture which can be reversed to restore growth. The sector can be built from the ground up,

but the process will be slow. Although development potential exists, the effects of decades of relative neglect can be overcome only gradually.

16. Forestry. Although exports of wood and wood products already amount to a substantial proportion of non-oil exports these could ultimately be substantially increased (perhaps two-fold) under appropriate conditions, particularly now that the more inaccessible timberlands have been opened up to exploitation with the completion of the Transgabon railway. However, with the substantial appreciation of the CFA franc vis-a-vis the dollar, Gabon is increasingly losing its competitive edge to exporters of tropical hardwoods such as Indonesia, whose exchange rate has followed the dollar. The problem is exacerbated by Gabon's high minimum wages and lack of flexibility in the hiring and firing of labor. Moreover, both domestic and international freight rates are also unfavorable to Gabon's exporters of forest products. Finally, the export monopoly of the parastatal SNBG (Societe Nationale du Bois du Gabon), whose marketing margin amounts to 16 percent of total fob price, has been a major obstacle to exports.

17. Industry. Gabon's small domestic market renders its industrial base extremely limited. The industrial production which does take place enjoys considerable protection, with effective protection rates averaging over 80 percent. This is reinforced by the quota system, which covers some 40 percent of domestic industrial production as well as by the liberal investment incentive regime. The structure of protection supports high private sector salaries, making industrial production uncompetitive. Outside of wood processing, there are few manufactured exports, mainly textiles.

18. Highway Transport. With the exception of agricultural feeder roads (about one-tenth of Gabon's road network) the existing highway network is largely adequate for the country's needs. However, the network is badly deteriorated and road transport costs are extremely high, running about twice the levels in countries such as Côte d'Ivoire and Senegal. Thus the cost of road transport from agriculturally productive regions to population centers accounts for a considerable share in the high marketing costs for local produce and has resulted in increased dependence upon imported foodstuffs. While some of the transport cost differences can be explained by high minimum wages, a substantial part of the problem is explained by the poor state of the roads and the low level of resources expended on current maintenance. The latter is only about one-fourth of requirements given technical conditions, usage, and climate. Indeed road maintenance has been neglected to the point where expensive rehabilitation is required.

19. Railway Transport. The construction of the 600 km Transgabon railway from Libreville to Franceville, a delicate subject which was at the heart of heated discussions between the Government and the Bank in the 1970s before Gabon graduated from Bank lending, has been virtually completed. Only complementary installations and protective civil works remain to be finished around mid-1988. Available results since 1984 indicate that it is one of the highest cost railway operations in Africa. This is due to: (a) excessive staffing; (b) excessively sophisticated and costly investments both in infrastructure and rolling stock; (c) costly

foreign technical assistance; and (d) lower than estimated traffic volumes. Thus, although tariffs are higher than most other railways, they do not cover operating expenses. In 1984, for example, there were operating losses of about CFAF 3.3 billion which were covered by government subsidy. The railway itself must be considered as a sunk cost which the Government should continue to operate as long as it can cover marginal costs. It is intended that radical cost reduction and efficiency measures covering all aspects of railways operations will be taken under the public enterprise component of the structural adjustment program. Privatization of OCTRA, as a means of improving efficiency, should be fully explored. Linked with railway transport is a recent agreement between the Governments of Gabon and Congo and the manganese company COMILOG to transfer 51 percent of the manganese exports from the Congo route to the Transgabon railway. This will require an investment in excess of US$100 million sponsored by COMILOG for a new mineral port in Gabon (Owendo), ore handling facilities at both terminals and railway locomotives and rolling stock. As part of the proposed SAL it would be necessary to investigate the extent of cost recovery by OCTRA.

20. Oil. Since the early 1970s, the pace of economic activity in Gabon has been to a large extent determined by the variations of international oil prices and of domestic production of crude oil. For the foreseeable future, oil will remain the main driving force of the Gabonese economy and to a considerable extent the mainstay of its foreign exchange earnings: in 1985, the petroleum sector accounted for 82.5 percent of merchandise exports; in 1986, even with oil prices at their lowest levels, they represented 65 percent of the total.

21. The oil sector in Gabon has few real backward or forward linkages with the rest of the economy. Oil companies themselves undertake a major part of their own construction and infrastructure investments, import most if not all intermediate inputs including non-factor services, and employ relatively few nationals. As a consequence, the influence of the oil sector on the non-oil economy is almost entirely a financial one whose impact is felt through the public budget.

22. The production profile of the Gabonese oil sector for the next ten years is determined by two factors: the expected levels of crude oil extraction from existing fields and the development of new fields such as Rabi (a major new field being developed jointly by Shell and Elf). While the 1986 collapse of oil prices has dampened oil companies' interest in undertaking new exploration, they are taking a longer-term view with respect to their development plans. This is especially the case for Rabi, whose exploration and development costs are expected to amount to nearly US$800 million of which some US$150 million have already been spent and whose output is critical for the realization of the base case projections. Shell and Elf are continuing with their plans to develop the field, production is expected to start in 1989, and full capacity (4 million metric tons per annum) is expected to be reached in 1991. Forecasts for the existing fields show production being maintained at around 8.2 million metric tons per annum until 1988, and declining thereafter. However, total production is expected to expand until 1992 to approximately 9.4 million metric tons, because the development of Rabi and other smaller fields will more than compensate for the natural decline in the existing ones.

Although production forecasts for 1993-95 are not as reliable as those for earlier years, a major new discovery recently announced suggests that production could be maintained beyond the year 2000. Since variable marginal costs have been estimated for Gabon to be substantially below US$10.00 per barrel, there are strong incentives for the oil companies to continue to produce as long as export prices exceed US$10 per barrel.

23. The Current Crises. Gabon's current macroeconomic problems have their origin in the exceedingly ambitious public investment program that has had little to do either with economic yields or the satisfaction of basic needs. The rural areas remain backward; the basic health, infant-mortality and educational indicators are not better than those of much poorer African countries. Although primary education rates are high, total secondary level enrollment rates are some 50 percent the levels of the higher income developing countries. The productivity of the educational system is generally low, with a high proportion of repeaters and dropouts, and graduates are generally ill-prepared for work outside the civil service, particularly in the productive sectors.

24. Investment projects have in good part either been prestige ventures or pet projects of influential ministers. Thus more than US$2 billion -- over one-third of the total Government investment during the period of its construction -- was spent on the Transgabon railway; estimates suggest that the project cost from five to ten times what it should have. The Bank was requested to participate in this project in 1971, but rejected it because of its unacceptably low rate of return. Other, similar projects have been regional and national airports, administrative infrastructure, and a recent expansion of the TV network nationwide, as well as schools, urban hospitals and rural dispensaries for which staff and equipment has been unavailable. 2/ In general, there has been little real control over the capital budget and lucrative parastatal sector jobs have often been used to buy off the political opposition.

25. At the same time, the long neglect of the non-oil productive sectors limits Gabon's medium-term growth potential and non-oil GDP is not expected to show positive growth before 1989. The decline will be entirely due to the contraction of oil-supported non-tradeables, and growth in tradeables is not expected to offset this decline until 1989. After that date, overall growth in the non-oil economy is expected to average about 3.3 percent a year. 1995 non-oil GDP will probably be some 20 percent below its 1985 peak, and it is likely that the 1985 figure will not be reached again before the year 2000. However, while oil is not expected to regain the importance it had in 1984-85 during the period under consideration, resource flows from the sector will be sufficient to finance adequate levels of investment for the productive sectors, gradually reestablishing the viability of the non-oil economy on a longer-term basis.

2/ Some of the latter were cancelled in the reprogramming of investments (para 34).

26. The sharp fall in the terms of trade which Gabon has experienced since 1984 led to an appreciation of about 40 percent in its real exchange rate. The actual overvaluation of the CFA franc in Gabon is, however, estimated to be substantially higher. Normally, this would justify a devaluation, and indeed, this is what has taken place in oil-exporting countries such as Indonesia and Nigeria. However, under the terms of its membership in the franc zone, devaluation of the CFA franc on an individual country basis is at present ruled out. Thus the only realistic way in which Gabon can adjust is through a real realignment of the CFA franc; i.e., an increase in the relative prices of tradeables compared to non-tradeables. However, this adjustment must be accompanied by a major reduction in aggregate demand. In addition, since real wage reductions are unlikely to be sufficient to re-establish fully the competitiveness of Gabon's non-oil sector, a tariff and export subsidy scheme -- equivalent to a nominal correction of the exchange rate -- should be considered.

IV. THE PROPOSED STRUCTURAL ADJUSTMENT PROGRAM

27. The medium-term objective of the Gabonese authorities is to reestablish economic growth and full creditworthiness by re-orienting the non-oil economy away from oil-financed non-tradeables towards increasing the productivity of land, labor and capital in the tradeables sectors and in this way reduce the country's dependence on oil for economic growth. To achieve this, the Government has adopted a strategy that includes:

(a) a stabilization program supported by the IMF to reestablish macroeconomic equilibria in line with the long-term depletion of oil resources;

(b) a correction in the real exchange rate through a combination of wage, trade and price policies and other cost reducing measures in order to improve the competitiveness of the tradeables sector; and

(c) a series of interventions at a sectoral level, essentially in agriculture and transport, that address some of the impediments to sustained growth.

28. The implementation of this structural adjustment strategy will entail short- and medium-term measures in wage policy, the trade/investment code/price control regimes, the parastatal sector, public resource management, agriculture and forestry, and transport. The Government's draft SDP and a policy matrix are attached (Annex I).

Wage and Labor Policy

29. High wage rates are a serious impediment to increasing Gabon's competitiveness. For example, the minimum wage (SMIG) is at CFAF 64,000 (44,000 for non-Gabonese) per month, about three times that of Cameroon and Congo. To redress the civil service payroll situation, the Government has already, under the stabilization program, reduced non-indexed indemnities (housing allowances, etc.) by 45 percent, implying an average salary cut of

9 percent. A further cut in the civil service wages index will take effect on January 1, 1988 and is expected to result in a 10 percent decline in the wage bill. These measures, in addition to being key elements in the fiscal stabilization program, should have important effects on salary levels in the parastatal and private sectors. In the parastatal sector, the authorities will align the salaries of managers to those in comparable positions in the civil service and will require parastatals to prepare "salary packages" to bring about average salary reductions of between 20 and 30 percent. In the private sector, the induced effects of the reduction in public and parapublic salaries and the impact of the sharp cut back of investment expenditures on the labor market and wage levels, will be complemented by a 10 percent reduction in the SMIG, its suspension for SMEs, the creation of a rural minimum wage (SMAG) 25 percent below the SMIG currently prevailing in all sectors, and reforms in the price and investment regimes that presently sanction the high wage/price structure. In addition, labor legislation will be revised so as to provide for easier firing of non-productive labor and seasonal hiring. During the implementation of the stabilization and structural adjustment programs, the Government would consider the possibility of taking further action in this area, if needed.

Trade, Investment Incentives, and Price Controls

30. Gabon's trade, investment and price regimes are poorly structured and have led to a misallocation of capital and labor resources and, perhaps more importantly, have sanctioned the prevailing high price/wage structure. While a relatively high proportion of domestic production is protected by natural monopoly, about 40 percent of industrial output (excluding wood production for exports) is protected through a restrictive regime of QRs known as "certificats de carence", whereby potential importers need permission from local producers to import. The benefits of the certificat de carence regime are negotiated under the investment code, and have no time limit. Even for producers that do not benefit from quotas, practically all local production receives continuing fiscal benefits under the investment code, including virtual exemption from import duties. These duties are generally ad-valorem tariffs, varying from 0 to 200 percent and averaging about 60 percent. There are two results of this regime. First, it leads to high and dispersed levels of effective protection; estimates vary from negative in the wood sectors to 300-600 percent in textiles and chemicals, and average some 80 percent. Such measures provide mainly for the protection of domestic value-added, sanctioning the high wage levels found in Gabon. Second, the regime discriminates against local production because, while imported inputs are duty free, taxes must be paid on local inputs and capital equipment.

31. Recognizing the above, the Government has agreed to: (a) progressively replace virtually all QRs (except for cement, sugar, and palm oil) by ad-valorem tariffs ultimately to be set at a maximum of 80 percent (120 percent for luxury goods); (b) for those items not under the QR regime, reduce the maximum tariff over the program period to those specified above in (a), with intermediate levels set at 100 percent and 150 percent respectively; and (c) revise the investment code. It is expected that three years after the start of the program, the modal tariff level would be approximately 60 percent, which together with the revision

of the investment code, will reduce the dispersion of effective protection considerably. The reform of the investment code will reduce excessive import substitution support and the (virtually permanent) lifetime of most benefits, and limit most duty and tax benefits to exporting industries. However, the medium term objective in these cases, to be achieved during the adjustment period of which the proposed SAL program is only the first stage, are: (a) to put in place a fairly uniform and liberal tariff code that nonetheless provides adequate protection to infant industries; (b) to further encourage the tradeables sectors by compensating for the overvaluation of the real exchange rate through an across the board import tax export subsidy scheme 3/ ; and (c) for all those goods presently under the QR regime, provide, if necessary, additional temporary protection over and above the tariff code so that affected industries may adjust to the new trade system without major disruption.

32. Price regulations in Gabon are similar to those prevailing in UDEAC countries. Price controls are maintained for both domestic and imported products. The rationale for these is that the establishment of local monopolies (e.g., by certificats de carence) requires a limit on potential abuses. In addition, it is argued that the domestic market is too thin to permit much competition among imported goods. This justification for price controls will need to be studied during the appraisal of the SAL. In any event, there are elements in the price regime that merit immediate attention: (a) reduction of domestic prices in line with the cost reduction resulting from the decline in wages; and (b) equalization of retail and wholesale margins for imported and domestic goods of a similar nature. Government intends to liberalize the pricing system once the competition issue is resolved.

The Parastatal Sector

33. Gabon's parastatal sector consists of some fifty public enterprises whose activities spread across all sectors of the economy but are concentrated on services, including marketing. The sector accounts for 20 percent of value-added in the non-oil economy and has the usual problems of overstaffing, poor cost control, high salaries, ineffective oversight and general lack of performance criteria. Sector subsidies totalled CFAF 19.3 billion in 1986. However, more importantly, the competitiveness of the productive sectors which use high cost parastatal services cannot help but erode. To reduce the parastatal sector burden on the economy, Government will, in addition to reducing wages (para 29): (a) liquidate or privatize seven public enterprises including SNBG (wood marketing) and SONADECI (coffee and cocoa plantations); (b) set up monitoring mechanisms and clearly define the institutional relationships between the State and the enterprises; (c) restructure sector finances; (d) declare a five-year moratorium on creating new public enterprises and define financial criteria

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3/ The effective protection levels resulting from this scheme together with the tariff code should not be overly high. In addition, the administrative costs of this scheme will be weighed against possible benefits.

for future State involvement; and (e) change the sector's economic environment and improve its management.

Public Resource Management

34. The steady flow of oil resources in the past has permitted substantial current government savings and made substantial public net borrowings possible. As a result, public capital spending was not subject to stringent control, in terms of either its overall size or its composition, and the recurrent cost implications of the investment program were not assessed. In addition, a substantial proportion of this spending has been outside the budget, and there has been no financial planning to smooth the boom/bust oil cycles so destabilizing to the economy. During the preparation of the IMF standby, and following a review of the public investment program by the Gabonese authorities themselves, IBRD staff reviewed the said program. Compared to 1985 when public investment expenditures reached CFAF 404 billion, the government adopted a program of CFAF 92 billion in 1987 and CFAF 73 billion in 1988 thus eliminating non-priority projects. The key instrument to improve public resource management will be a three-year rolling public finance plan ("loi programme"), the first to be prepared for September 1987 for the following three years. This rolling plan would include the budgetary impact of all current and new investments and set out the financial and economic policies, as well as the sectoral strategies, necessary for the full beneficial impact of the investment program to be felt. The authorities will also take measures to eliminate all extra-budgetary expenditures in the context of the IMF standby.

35. As suggested above, financing of the investment plan would include not only ordinary receipts, but expected borrowing and the management of resources in the proposed Petroleum Reserve Fund. The latter would include all revenues from the petroleum sector except for the relatively constant royalties. As proposed, the Fund would be managed so as to smooth the flows from the petroleum sector to the budget, thereby avoiding the damaging boom/bust cycles of the recent past, in a manner similar to that recently agreed with the Congo. The Petroleum Reserve Fund would not be used for projects other than those in the approved public investment program. Projects would not be included in the public investment program unless they have been subjected to a thorough economic and financial appraisal.

Expanding Produtive Activities

36. In addition to tackling the wage issue noted above (para 29), in agriculture the authorities plan to: (a) abolish the food crop "prix mercuriales"; (b) replace the stabilization boards for coffee and cocoa by a single new entity whose only role would be to guarantee a floor price leaving marketing to the private sector; (c) replace SONADECI, the large, inefficient, and unsuccessful coffee and cocoa parastatal by SOCAGAB, a lighter structure with private sector participation; (d) examine possible reintroduction of the 40 percent tariff on imported meat, and increasing the current 10 percent rice duty. More broadly, the Government will prepare an updated agricultural development strategy.

37. The most important measure affecting the forestry sector will be the abolition of Société Nationale du Bois du Gabon (SNBG), the state monopoly for the marketing of Gabon's two principal forest products, okoumé and ozigo. Thus the sale of these species would be completely liberalized as is already the case for other species. In addition, it is envisaged that the rail tariffs will be lowered following rationalization of OCTRA, and the exoneration of export taxes (now between 10 and 15 percent) will be considered, in light of the proposed across the board export subsidy. As with agriculture, the Government intends to prepare a forestry sector strategy which would examine the conditions for doubling wood and wood product exports in seven years and include reforestation and conservation programs. The environmental impact of such an expansion will be examined during both the SAL missions and sector work.

Transport

38. In transport, the Government's efforts need to focus mainly on consolidating and strengthening existing infrastructure and reinforcing its management capacity through institutional reforms, particularly in the Ministry of Transport. OCTRA will be made more efficient and viable under a private management contract and/or a contract plan. Emphasis would be placed on rehabilitating the existing highway infrastructure according to the economic priorities of the updated 1978 and 1982 national transport plans; rehabilitation would be followed by a well-designed and coherent plan for maintenance. The high cost of local transport services would also be examined, with regard to OCTRA and rate setting policies as well as to other state enterprises in the sector, OPRAG (local port facilities) and Air Gabon.

39. Management and Administration of the Adjustment Program. Government has decided to establish a "Commission de Gestion de l'Economie, Chargée de la Restructuration", headed by the Prime Minister to manage the structural adjustment program and coordinate with the donor community. This commission would also include the Minister of Finance and Plan, the High Commissioner for Planning and the Economic and Financial Adviser to the President. In addition, a permanent technical commission would be established headed by the High Commissioner and the President's Adviser.

V. Macroeconomic Prospects and External Capital Requirements

40. The base case scenario described below assumes the implementation of a coherent macroeconomic reform package which addresses Gabon's main development constraints. The three fundamental and interrelated macroeconomic objectives which Gabon must meet during the next decade are: (a) reestablishing macroeconomic equilibria in line with a long-term reduction in oil resources; (b) reducing the country's dependence on oil for economic growth, and -- consistent with (b); (c) reorienting the non-oil economy away from oil-financed non-tradeables towards increasing the productivity of land, labor and capital in the tradeables sectors. These goals are expected to be brought about by the implementation of a stabilization package involving sharp cuts in aggregate demand through a series of measures to lower labor costs and increase labor mobility. In addition,

better conceived government investment policies should work to enhance factor productivity. Finally, reductions in the overall domestic cost structure through public enterprise reforms and the consequent reduction in the cost of services performed, should be an important contributing element of the program.

41. Annex II outlines the base case. The first phase, 1986-88, will be one of sharp reduction in aggregate demand resulting from the precipitous drop in the government's capital and current expenditures necessitated by the fall in oil revenue. This cut in aggregate demand is exacerbated by the fact that generally poor past economic management and export prospects preclude substantial additional external borrowing to compensate for oil revenue loss despite a relatively comfortable debt service position. The second phase, from 1989 onward, will be characterized by a resumption of growth in non-oil GDP, together with a gradual realignment within the non-oil sector towards tradeables as a result of the implementation of structural adjustment measures. Because growth should come in large part from factors released from the non-tradeable sectors to the tradeables sectors, import growth over the period should be relatively restrained.

42. During the stabilization period, non-oil GDP in constant prices is forecast to decline by 35 percent from CFAF 858 billion in 1985 to CFAF 554 billion in 1988, mainly as a result of the expected 65 percent real decline in non-oil investments. The economy-wide cuts in nominal and real wages, the expected unemployment resulting from the reduced activity in construction and related sectors and the freeze in civil service employment all point to a sharp decline in consumption, which would fall in real terms by about 36 percent between 1985 and 1988. The non-oil economy is expected to stabilize in 1989 and thereafter gradually expand at an annual real average rate of 3.3 percent until the end of the forecast period (1995). Tradeables value-added is forecast to grow in real terms during this same period at an annual average rate of 4.9 percent. However, even by 1995 real per capita GDP will still be 35 percent below 1985 levels.

43. In the base case scenario, the share in total non-oil GDP of value-added in tradeables (agriculture, forestry, mining, and manufacturing) is expected to increase from 30.5 percent to 46 percent between 1985 and 1995. The reform of the tax and trade regimes, the reduction in real wages with increased labor market flexibility, the revamping of the investment code, and the elimination of some state monopolies are all expected to enhance the effect on the real exchange rate of the sharp cut in government expenditures. At the same time, direct sectoral intervention, particularly in agriculture, will be required to bring about the expected re-orientation of the economy. Mining, agriculture and forestry and possibly fishery offer export potential. Because the economy and cost structure have been skewed for so long, it is difficult to specify areas of potential comparative advantage for export production outside of wood processing and possibly agro-industry. This will be an area for future sector work. Non-oil exports are projected to increase at an annual rate of 2.6 percent and 6.5 percent during the stabilization (1986-88) and adjustment (1988-95) periods, respectively, mainly as a result of the expected doubling of wood products exports during the forecast period.

44. Stabilization and adjustment efforts are also expected to lead to changes in the composition of aggregate demand. The share of non-oil investment (in non-oil GDP) is forecast to decline most, from 42 percent in 1985 to 17 percent in 1988, largely because of the direct and indirect impact of the 85 percent public investment reduction. Although required adjustments in absorption are mainly taken up by the 73 percent decline in real non-oil investments, a sharp fall in private and public consumption (-36 percent) will also be required.

45. Throughout the adjustment period following 1988, the fall in financial resources of the Gabonese economy -- including a reduced recourse to external borrowing -- leads us to project the share of non-oil investment in non-oil GDP as rising only slightly, from 17 percent to about 20 percent between 1988 and 1995. This appears to be roughly consistent with Gabon's absorptive capacity. The authorities intend to concentrate their investment efforts in the productive sectors (especially agriculture) as well as in the rehabilitation of key road infrastructure. Priority will also be given to social sectors, especially education, in order to improve the human resource base. Government investment expenditures are projected to grow by about 10 percent per annum (from sharply reduced levels) in real terms from 1990 onwards; private investments are expected to expand gradually in line with non-oil GDP as a result of the more favorable policy environment. The revision of the investment code, the improved capital budgeting techniques and the real devaluation should provide the environment for improving the efficiency of investment.

46. With respect to the budget, oil revenues are expected to decline sharply during 1985-87 from CFAF 400 billion to CFAF 70 billion. As a result of the associated decline in non-oil GDP, non-oil tax revenues are also expected to decline from CFAF 206 billion to CFAF 157 billion during the same period. Relative to total revenues, oil revenues fall from 63 percent to 27 percent during the same period. Starting in 1988, oil tax revenues are expected to increase, in line with the projected increases in oil prices and oil production. Similarly, non-oil tax revenues are expected to increase in line with the projected increases in non-oil GDP. Non-oil tax projections are based on a conservative assessment of the future resource mobilization effort. During 1988, in the context of the IMF standby program, the authorities plan to introduce measures to increase non-oil fiscal revenues through improvements in tax administrative procedures (including technical assistance in customs valuation). Nonetheless, non-oil tax revenues as a percentage of non-oil GDP are projected to remain approximately constant at 25 percent through 1995. Expenditure projections are consistent with the stabilization and adjustment programs. Current expenditures are expected to decrease (especially wages and salaries) during the stabilization period 1986-1988 and thereafter remain constant in real terms. As mentioned above, public investment expenditures, after an initial sharp reduction, are projected to expand by approximately 10 percent per annum in real terms starting in 1990 in order to implement priority projects in the productive and social sectors.

47. The current good standing with the IMF reflects the implementation of many stabilization measures and some structural adjustment measures. Yet, an alternative to the base-case scenario could

be presented, assuming a lukewarm Government commitment to the structural adjustment process. In such a case, the most likely slippages would be in investment programming, salary reduction, forestry reform, and trade and price reform. These slippages would result in less efficient public and private investments, lesser growth in the tradeables sectors including exports, lower overall non-oil GDP growth and a considerably more precarious internal and external balances. The objective of reversing the dependency on oil would not be achieved, and medium-term creditworthiness would be open to question. It is this outcome that the SAL is designed to prevent.

48. External Financing Requirements. The external financing requirements of the base-case scenario (after the rescheduling of the eligible debt service due in 1987 and 1988 and excluding private non-guaranteed debt) imply gross foreign borrowing of approximately US$1.6 billion, or about US$260 million per annum, over the 1987-1992 period (Table 3). The disbursement profile for public and publicly guaranteed debt, including IBRD, over this period shows annual average gross disbursements of about CFAF 61 billion (US$198 million). This represents a sharp reduction from the annual figure of CFAF 125 billion (US$316 million) over the 1984-86 period, and reflects the new difficulties faced by the Gabonese authorities in their search for external financing. These projected disbursements are consistent with the public investment program and include disbursements from loans committed before end December 1986, as well as from firm commitments in 1987 and projected future commitments. The latter include IBRD, other multilateral, bilateral and private sources and are based on analysis of past disbursements, French support for Gabon's adjustment program, and the gradual improvement in creditworthiness resulting from stabilization and adjustment efforts and the expected increase in oil production. However, over the period 1987-92 there will remain a financing gap of about US$370 million. Of this gap, only US$3 million occurs in the first two years, which we expect will be financed by fresh money, and US$351 million occurs during 1989-1990, which would be financed by additional reschedulings and fresh money. Principal and interest payments eligible for rescheduling in 1989 and 1990 on debt outstanding disbursed before end 1986 are estimated to be US$470 million. Possible sources of fresh money are cofinancing of IBRD SALs (which has not been included in projected disbursements), bilateral sources and the IMF.

Table 3

Base Case Scenario

Gabon: External Financing Requirements
(US$ million)

	1987	1988	1989	1990	1991	1992
Current Account Balance:	-428	-393	-395	-289	-65	12
Amortization MLT Debt:	-195	-183	-414	-403	-354	-436
o/w Public and Guaranteed:	-47	-17	-237	-213	-180	-271
Private:	-148	-166	-177	-190	-173	-164
IMF (net):	26	67	0	-17	-28	-31
Change in Reserves (net):	95	-28	-18	3	22	22
Total Financing Requirements:	-502	-537	-827	-706	-424	-432
Drawings Public and Guaranteed Debt:	292	200	189	155	171	182
o/w Existing Commitments 12/31/86:	197	163	100	33	5	2
Firm Commitments 08/31/87:	95	2	1	0	0	0
o/w CCCE:	45	2	1	0	0	0
London Club Deal:	50	0	0	0	0	0
Projected New Commitments:	0	35	88	122	166	180
o/w Concessional:	0	3	10	18	26	30
IBRD:	0	15	24	24	38	22
Bilateral + Other Multi.	0	17	31	42	47	60
Suppliers credits:	0	0	3	8	15	23
Other Private	0	0	20	30	40	45
Drawings Private Debt and DFI:	455	558	513	358	239	250
Other Capital Flows (net): 1/	-245	-223	-67	33	0	0
Total Financing	502	534	635	546	410	432
GAP 2/	0	3	191	160	14	0
Memorandum Items						
Debt Service Rescheduled (Paris and London)	316	322	NA	NA	NA	NA
Debt Service Available for Resch.	NA	NA	270	207	NA	NA

Note: 1/ Mainly short-term capital flows from the oil sector.
2/ Projected gaps do not take into account debt service on gap financing.

49. The adjustment scenario outlined above is therefore supported by a financial strategy that requires both additional rescheduling and fresh money. The combination of the structural adjustment program together with the financial strategy would lead to a stabilization of the fiscal and balance of payments situations, and therefore maintain creditworthiness over the medium term. The IBRD lending program, heavily oriented towards policy-based and fast-disbursing operations, is included in the gross disbursement projections. The share of the IBRD in total gross disbursements of public and publicly guaranteed debt (excluding reschedulings) increases to a peak of 22.2 percent in 1991, and then falls rapidly thereafter as a result of the decline in the lending program itself and the projected increase of disbursements of other creditors as Gabon's debt servicing capacity improves in parallel with oil prices.

50. Creditworthiness. The dramatic fall in oil export revenues has significantly worsened the financial position of the Gabonese Government. Debt service as a percent of exports of goods and non-factor services was expected to deteriorate from 11.1 percent in 1985 to 25.9 and 29.1 percent in 1986 and 1987, respectively, before rescheduling. The late-1986 rescheduling brought the 1986 and 1987 DSRs to 18 percent and 7 percent, respectively. The expected 1988 rescheduling will maintain the same debt-service ratio in 1988. Given the relatively modest prospects for recovery in oil prices, much prudence is called for in managing the Government's external debt, and Gabon must remain on a narrow adjustment path for the next five or six years. However, the situation is not as dire as in other debt-ridden Sub-Saharan African nations, and the debt burden should be manageable. Even before the possible 1989 and 1990 reschedulings mentioned above, the debt service ratio would peak in 1989 at 26 percent, and would decline to 23 percent by 1995. Therefore, what the base case shows is that:

(a) on the basis of the reschedulings and the capital flows assumed for the period 1987-95, Gabon can be expected to meet its debt-service obligations, including those to the World Bank; and

(b) inclusion of a Bank lending program would ease the burden of adjustment and allow for greater flexibility in debt-service management policy.

51. In light of CFA zone regulations which provide for sharp restrictions on Government access to Central Bank credit, the Government must generate budgetary savings in order to purchase foreign exchange for its external debt-service obligations. The base case fiscal projections (para 46 and Annex II, Table 7) show that external debt service is expected to be 37 percent of total revenues in 1989 and 29 percent in 1990. As a result, and taking into account the reduced access to external financing, there are likely to be substantial overall budget financing gaps during 1989-90. It is this element, and not the debt service burden, which necessitates rescheduling. Starting 1991, the budget position is expected to improve. On the basis of the reschedulings, conservative tax revenues and external capital inflows, and relatively tight expenditures assumed for the period 1987-95, the base case fiscal projections support the conclusion that Gabon can be expected to meet its debt service obligations.

52. Alternative scenarios were conducted for upside and downside risks, assuming either a 20 percent rise or fall in oil prices over EPD projections. If oil prices were 20 percent above expected price levels, the non-oil growth rate would be considerably higher (4.6 percent as opposed to 3.3 percent), rescheduling could be avoided in 1989 and the decline in private consumption reduced. However, there is some danger that higher oil prices could also bring about some relaxation of the authorities' efforts to press for adjustment. In any event, per capita GNP would remain below IBRD graduation levels until the early 90s at least. Similarly, oil price levels postulated at 20 percent below EPD projections would require even sharper contractions in consumption and investment than those in the base case scenario. Gabon's creditworthiness would become marginal without further stabilization and adjustment measures. A more complete discussion of IBRD's projected exposure in Gabon is set out in Annex IV.

The Social Impact

53. There is little doubt that medium-term equilibrium will require sharp cuts in both total non-oil investments as well as in consumption: over the next few years, per-capita consumption may have to decline by as much as 40 percent, not only because of the direct effects of the fall in oil prices, but because this fall will impose a substantial reduction on Gabon's capacity to borrow, and consequently on net external resources available to it. This means that under the base case scenario it will take more than a decade for living standards to recover to their 1985 levels.

54. The proposed Structural Adjustment Program will not prevent negative social effects from the necessary stabilization measures but it will considerably ease them. The reduction in the administration's wage bill will be achieved for the most part through salary cuts and not from cuts in the number of civil servants. The labor market in present circumstances would not be able to absorb a large number of displaced civil servants. The greatest impact on employment will come from the sharp cut backs on public investments and reduced activity in the non-tradeables sectors. On the positive side, the structural adjustment measures, by creating a more favorable macroeconomic environment for the expansion of the productive sectors and increasing mobility in the labor market, will over time provide alternative employment opportunities that would otherwise be unavailable. As a result, non-oil GDP per-capita is expected to expand by 1.1 percent per annum during the adjustment period 1989 to 1995. Government expenditures will be reviewed to ensure that the total as well as the composition of public expenditures on basic services are protected and, if necessary, redirected to benefit the most vulnerable groups. Other components of the program will in the medium term help enable the poor to participate in the process of renewed growth; for example, the agricultural marketing, extension and research project will reinforce extension support and other services provided to farmers, and the SME project will, *inter alia*, help improve access to credit in both rural and urban areas.

55. Although the austerity measures will be severe, per-capita incomes in Gabon will remain over US$2,500, or some two to three times higher than those of neighboring countries, so that real privations should remain limited: the proposed agricultural minimum wage will remain

75 percent over that of Cameroon. In addition, part of the burden will be absorbed by expatriates, some of whom are expected to return to their native lands. Nonetheless, it is possible that certain privileged groups will be more able than others to protect their living standards. Measures will be introduced to monitor the impact of the program on the poorer segments of the population and to help design corrective (or preventive) actions.

VII. Bank Assistance Strategy

56. Past Bank Assistance. Between 1959 and 1974 the Bank made seven loans to Gabon in the mining, highways, water supply and education sectors for a total of US$69.3 million. The last operation, an education loan for US$5 million was signed in 1974 and closed in 1983. In 1977, Gabon graduated from Bank lending and has now repaid all but US$9.45 million of its IBRD borrowing. Since 1977, our limited operations in Gabon have been undertaken on the same basis as in other oil-rich countries whose per capita GNP has taken them over the Bank's graduation level. In addition, the Bank is executing agency for a UNDP/Government co-financed technical assistance project designed to help the Government select and evaluate viable investment projects in non-oil sectors.

57. Relations between the Bank and Gabon have been difficult. The authorities were most unhappy with the decision to graduate Gabon from IBRD lending and repeatedly requested the Bank to reconsider. They also felt that the one year non-reimbursable technical assistance they were receiving from the Bank was insufficient and were particularly disappointed at the Bank's position on the Transgabon railway project. Finally, the Bank-administered technical assistance project made a poor start initially, mainly because the institutional goals were too ambitious and because of difficulty in filling the resident expert posts. The project is now running well: considerable collaborative effort from the project's resident experts went into the work of preparing the structural adjustment program. Mr. Conable's recent meeting with President Bongo provided a basis for building a new basis for our collaboration.

58. Resumption of lending. Current data suggest that per capita GNP in Gabon will have been slightly above the Bank lending threshhold in CY86, but will fall considerably below the threshold by CY87. According to Bank lending guidelines, this would not justify resumption of lending before FY89. However, at US$3080 Gabon's per capita GNP in CY1986 is only marginally above the 1986 graduation level of US$3010. In CY1987 it is projected to fall to US$2560 and to remain below US$3000 through 1995. Given the urgency of initiating structural measures it has been agreed that lending should be resumed as soon as possible provided only that the first operation is in support of a credible structural adjustment program which convincingly reestablishes Gabon's creditworthiness. A full five-year lending program is justified in light of the duration of Gabon's expected adjustment period.

59. Resumption of lending to Gabon will allow us to respond to the Government's present openness to reform in the face of the current tight domestic financial situation: (a) lay the groundwork for a basic

repositioning of the Gabonese economy toward the non-oil productive sector, and (b) introduce a substantially greater degree of rigor in the management of public resources. Our objective would be:

(a) to reestablish Gabon's creditworthiness notwithstanding the sharp drop in oil revenues; and

(b) to steer investments towards increasing domestic productivity in the non-oil sectors, with the oil revenues being managed so as to minimize destabilizing cyclical fluctuations.

60. The keystone in this strategy would be a structural adjustment loan to support the Government's program as described above (paras 27-39) and summarized in the policy matrix (Annex I). Our expectation is that a minimum of two SALs will be required in order to help the Government achieve its stated objectives. The first SAL should be for an amount of US$35 million with a possible Japanese Loan of US$15 million equivalent, to be disbursed in two tranches. The first tranche of US$18 million, about 36 percent of the total of the two loans, would be available upon effectiveness and the second tranche of US$32 million would be released only after the Government had made satisfactory progress in implementing the program and specifically in meeting the conditions specified as second tranche conditions in the policy matrix (page 35 of Annex I). This policy matrix also specifies the Board conditions. The SAL program is based on the draft SDP (Annex I) which has been extensively discussed at the technical level though somewhat less at the political level in the Ministry of Plan. While the authorities have accepted in principle the majority of the measures in the proposed adjustment program, further details and a more specific implementation calendar need to be worked out and included in a revised SDP. Key measures on which the Government has reservations are the abolition of SNBG, the level at which to set the new SMAG, the reform in labor legislation, the elimination of QRs for all goods, and the abolition of marketing activities of the cocoa and coffee marketing boards. The introduction of an across the board tariff and export subsidy scheme has yet to be discussed with the authorities; in addition, price liberalization may be another outstanding issue if the SAL mission finds that price controls should be abolished in the short term. The proposed loans are expected to be disbursed over an 18-month period. They would finance about 2 percent of the import bill and 4 percent of the country's gross external financing requirements over the 1988/89 two year period, and would complement non-project and project financing from the FAC, EEC, CCCE, AfDB, IMF, and other creditors.

61. Country Economic and Sector Work. Despite the urgency to radically reorient the Gabonese economy, we would guard against overloading the first SAL with too broad range of policy reforms, thereby posing excessive demands on the Government's weak administrative apparatus. Moreover, because we have been inactive in Gabon for so long, our knowledge of the Gabonese economy is sketchy; some further sector work would be undertaken during FY88 to allow us to gain a better knowledge of important areas. A second SAL would then provide the opportunity for deepening the adjustment program once we have learned more about Gabon's economy. Although some sector work has been done in agriculture, forestry and fisheries, public enterprises, transport and energy in the context of SAL

preparation, as well as in a 1985 CEM, this work has not been sufficient for the preparation of sector-specific projects. For this reason considerably more sector work is required in areas outside the SALs where operations are being planned in the initial lending program, primarily in agriculture, but also in transport (particularly roads) whose rehabilitation will be necessary to support efforts in the agricultural sector. Consistent with this, a substantial agricultural sector review of 60 sw is planned for FY88. The environmental impact of the proposed expansion of wood exports will be thoroughly analyzed during the SAL preparation mission and the subsequent sector work. A transport sector review -- albeit somewhat more limited in scope -- is planned for the same year. In addition, sector work in public enterprises, education and population is planned for FY89-90. These tasks will be followed by a CSP and a CEM in FY89-90 as well.

62. The Proposed Lending Program. A total Bank lending program of approximately US$150 million is proposed for the next five years. This is an amount which -- although high on a per capita basis -- is consistent with the requirements of two SAL operations and four to five project operations which are essential if Gabon's economy is to be reoriented toward its productive sectors. The US$75 million proposed as quick disbursing assistance should be sufficient "seed money" to mobilize the additional funds needed to tide Gabon over its current balance of payments difficulties. In order to assist the authorities in the implementation of the adjustment program, a technical assistance project is planned for FY89 when the current Bank managed project ends.

63. The SAL will be essential in itself to assist Gabon's adjustment to the precipitate decline in oil export and budget revenues but if its objective of re-orienting the economy is to be achieved, it must also be accompanied by major investment programs in several sectors. Agriculture is clearly the major priority area, both with regard to institutions and productive investments, in particular those which will permit rapid absorption of unemployed factors released from non-tradeables investments. One operation is planned: a foodcrop marketing, extension and research project, scheduled for FY90. Forestry is also a sector of major importance, but the removal of structural impediments to its development as well as a reduction in salary costs are expected to stimulate increased private sector activity without requiring immediate external assistance. The planned operation in this sector is scheduled for FY91 and will provide the Gabonese authorities with technical assistance and institution building capabilities to prepare and implement a resource and environmental conservation program. Transport is another priority area, particularly given its importance for the agricultural sector and in light of the exceedingly high costs of the sector generally. Here, both major rehabilitation and on-going maintenance work is required going considerably beyond current Government budget allocations. Apart from feeder roads in heavily settled rural areas no new road building appears justified at this juncture. Bank operations in the sector will involve a highway rehabilitation and maintenance project scheduled for pre-appraisal for late 1989. Small- and medium-scale industry is another important area for Government action to promote diversification in the non-oil economy but, given CAM resource constraints, sector work in this area cannot be programmed at this juncture. Finally, sector work and a re-assessment of

investment priorities in education and health needs to be undertaken as a part of a longer-term investment program in order to help prepare redress the poor social indicators. In the context of analyzing the social impact of the adjustment program, the SAL preparation mission will undertake a first review of Government expenditures on basic services. However, CAM resources for further work in these sectors are not immediately available.

64. Aid Coordination. Given the above, it will be important to associate other donors, particularly those which are not now active in Gabon, not only with future Bank CESW, but also in renewed lending programs focussing on critical sectors. With respect to bilateral donors other than the French, World Bank involvement would very likely elicit expanded assistance from the Japanese, Canadians, Belgians and Germans. On the multilateral side, UNDP, FAO, AfDB and the EDF are all active in Gabon, with programs that are very pertinent to Gabon's underlying economic needs, but are not well integrated into the structural adjustment effort. Achieving greater mobilization and coordination of bilateral and multilateral assistance will be staff intensive, but the payoff could be considerable. For Gabon's adjustment efforts to succeed, donor coordination is essential.

65. The SAL program has been prepared in consultation with the IMF, and there has been close collaboration between IBRD and Fund staff, both in Washington and in Libreville. Bank staff assisted in the elaboration of the standby program, particularly on investment programming, national accounts and parapublic sector reform. IBRD managed technical assistance has provided technical analysis for several elements of the IMF program. The Government recognizes that continued stabilization is a pre-requesite for the success of its structural adjustment program and that the Fund program and the poposed SAL are interelated and complementary. This close collaboration will continue in the future.

66. Risks. The implementation of a structural adjustment as wide ranging as that described above, especially when IBRD has not been active in Gabon since 1974, is clearly not without risks. The principal ones are discussed below.

67. The sharp decline of oil prices during 1986 has resulted in the appearance of major disequilibria in the internal and external balance of the Gabonese economy, and consequently Gabon's creditworthiness has deteriorated. However, if Gabon's stabilization program continues on track, and structural adjustment takes place along the lines planned, there is little doubt that Gabon's creditworthiness can be reestablished. The base case scenario shows that as a result of the implementation of a financial strategy that includes additional rescheduling and the injection of fresh money, Gabon can be expected to service its debt during the period 1987-95. The debt service ratio for both 1987 and 1988 will be 7 percent and, even before the possible 1989 and 1990 reschedulings, this ratio would peak at 26 percent in 1989. This is true under all but the most pessimistic oil-price scenarios, increasingly unlikely as oil prices continue to firm up. The recently discovered large oil field will substantially improve this already manageable position. For historical reasons, overall Bank exposure is already quite limited and will remain so over the next decade. The Bank's risk in lending to Gabon is thus not

particularly high, especially in light of the willingness evinced by the international financial community to reschedule Gabon's debts on favorable terms.

68. The main risk lies in the pressure that may be placed on the Government to slow down the pace of reform. Important sources of such pressure are likely to be the public employees who have seen their real incomes decrease as well as the workers in private enterprises who lost their jobs as a result of stabilization. However, part of the burden will be absorbed by expatriates, and per-capita incomes will remain over US$2,500, so that real privation should remain limited. Nonetheless, the authorities are aware of these difficulties and will be expected to identify actions during the next stage of the preparation of the adjustment program to protect basic social expenditures and assure that the poorer segments of the population are not obliged to accept the greatest cuts in living standards. In addition, that the IMF program is on track augurs well for the Government's future resolve in implementing these difficult stabilization measures.

69. The Government's adjustment program is fairly comprehensive and will entail the introduction of new processes of economic management. There is the risk that the administration's ability to implement the program fully may not match its commitment to reform. The existing and proposed IBRD executed and/or financed technical assistance will substantially alleviate this risk, as will the technical assistance provided by bilateral donors and the carefully worked out arrangements by the Government for high level and technical supervision of the programs' implementation. In addition, a considerable amount of supervision support has been allocated in the CAM.

REPUBLIC OF GABON

DRAFT DECLARATION

OF

DEVELOPMENT STRATEGY

STRUCTURAL ADJUSTMENT PROGRAM

March 25, 1987

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INTRODUCTION

The Gabonese economy has been essentially based on petroleum, wood, uranium and manganese for a number of years. Nearly all other significant economic activity is dependent on the very high level of State expenditures made possible by budgetary revenues from petroleum. Aware of this situation, the Gabonese Government has for some time been considering how to prepare for the "post-oil" era. The main lines of its thinking are reflected in the structural adjustment program described here.

Since early 1986, Gabon, like other petroleum producers, has suffered from the fall in the price of petroleum products and the decline of the dollar. Public revenue from the petroleum sector has dropped from CFAF 400 billion in 1985 to an estimated CFAF 70 billion in 1987. Since then the rise in the dollar price of petroleum has been offset by the depreciation of the dollar itself and there is little reason to hope for any significant rise in petroleum revenue in the near future.

To meet this new situation over the short term, the Gabonese government began in March 1986 to introduce measures to limit the budget and embarked on the elaboration of a stabilisation program in concert with the International Monetary Fund and the World Bank. This program is aimed at reducing domestic absorption significantly through reduced levels of consumption and of public investment in keeping with the reduction of petroleum resources.

This stabilisation program was confirmed by a stand-by agreement with the IMF in December 1986 and led to the opening of negotiations aimed at the rescheduling of Gabon's debt service and the mobilising of further concessional financing from the international community.

The program includes a number of classic budgetary and monetary measures. These include:

(a) the reduction of operating costs from CFAF 240 billion to CFAF 200 billion and the reduction of investments from CFAF 400 billion to 90 billion in two years;

(b) a relative drop of about 20% in civil servants' salaries; and

(c) restrictions on the availability of credit to the economy and to the Government.

The program includes other elements which, because of their economic scope, are in effect structural adjustment measures:

(d) review of the economy-wide salary structure;

(e) reduction of consumer subsidies;

(f) elimination of constraints on production such as posted values; reform of the public enterprise sector and establishment of the appropriate institutional framework (including privatization or liquidation of five enterprises already identified); and

(g) tighter management of Government investments through a rolling investment planning system and the elimination of extra-budgetary expenditures by decree.

Moreover, in addition to this short term program, the Gabonese Government, aware of the unforeseeable nature of oil prices in the medium term and of the excessive dependence of it's economy and finances on these prices, has set itself the objective of using the resources which will be progressively freed up by the reduction in public absorption to restructure the nation's economy and reorient it toward non-oil productive sectors. The Gabonese Government has approached the World Bank for help in identifying ways and means to achieve this objective: their efforts and those of two World Bank technical assistance missions have led to the following conclusions and diagnoses:

(h) the private non-oil productive sector, crucial to future economic development, is uncompatitive on world markets and unable to expand in Gabon's present circumstances because of high costs, particularly salaries;

(i) current salary levels (reduction of which is a central point of the present program) have been made possible by the existence of a sizeable oil sector generating revenues sufficient for the payment of elevated salaries, to nationals and expatriates, in the oil sector as well as in the Civil Service and above all in the parastatal sector. Salaries in the rest of the economy followed with comparative ease since this did not entail any balance of payments costs given the fact that the country did not depend on non-oil sectors for exports.

In the face of this situation and in the absence of international inflation which at other times might have facilitated a _de facto_ devaluation through a wage freeze, three solutions are theoretically possible:

(j) nominal devaluation (excluded by Gabon's membership in the franc zone);

(k) a simulation of the effects of devaluation through increases in import duties and taxes and through the possible introduction of export subsidies, one financing the other; or

(l) direct action in the area of macroeconomic aggregates (reductions in levels of public investment, salary cuts), which would, in

principle, stimulate the tradeables sectors and be equivalent to a real devaluation.

PART I - THE PRESENT SITUATION

Economic Reorientation and Constraints

1. The measures already implemented under the stabilisation program supported by the IMF, i.e. salary cuts and the reduction of public investment in the non-productive sectors alone, represent a significant drop in economic absorption. They have tended on the one hand to induce a general reduction in salary levels and on the other to free up resources, in particular labor, which were previously used in the non-tradeable sectors (for example, contruction) and are now available to the tradeable sectors (agriculture and related activities, SMEs, etcetera).

2. Thus the process undertaken with IMF support is an important step toward reorienting the economy of Gabon to the productive sectors. It is however important to note that there exist in Gabon certain institutional hurdles which may make any automatic reallocation of factors to the productive sectors difficult. These hurdles include: i) a certain inflexibility in the setting of salaries, linked in particular to the size of the Civil Service, the parastatal sector and the service sector which serve as reference points for the labor market; ii) a trade régime, in particular the quota system, which introduces a high degree of rigidity in the allocation of resources and which, via the system of price controls, sanctions a very high cost and price structure and affects the whole of the economy and hampers its competitiveness; iii) the existence of a parastatal sector which by virtue of the natural or tariff protection it enjoys, is able to pay high salaries and maintain excessive manning levels; and iv) the serious constraints on the productive sectors, above all agriculture. Among the most significant of these constraints are a) producer prices which offer insufficient incentives relative to minimum wage levels, b) cumbersome marketing arrangements for cash crops (coffee and cocoa), c) food crop prices (mercuriales) which may not take account of producers' costs and the real revenue needs, d) a serious lack of adaptive research, extension and farmer support services, e) the lack of adequate, passable roads, f) an administrative superstructure which hampers the creation of an SME sector, and g) labor regulations which are poorly adapted to present circumstances.

Medium Term Allocation of State Resources

3. The existence for a time of high levels of revenue from petroleum followed by their sudden disappearance has had a very negative effect not only on the management of the economy in the strict sense but also on the way public resources have been used. Massive investment expenditures have been incurred which have far outstripped absorptive and managerial capacity and led to serious cost overruns in investment projects, the implementation

of projects with poor rates of return, a weakening of the competitiveness of the non-oil sector (a process compounded by the structural environment referred to above), and the establishment of educational and social facilities without any corresponding technical or financial provision for their operation.

4. Better planning in the area of public expenditure appears therefore to be indispensable. This planning should be based on a financial mechanism which will permit regulation of expenditure and optimal financial management per se. Only if resource flows (in particulra those from the oil sector) are propoerly managed can any rolling plan system, especially for investments, be established. Naturally, the impact of unexpected increases in resources could be easily absorbed by a solid portfolio of projects which have been identified and appraised.

PART II - DEVELOPMENT POLICY

5. On the basis of the above, the Government of Gabon envisages a program of action in five areas:

(a) a policy of structural adjustment in the strict sense which would include measures concerning the private sector environment, in particular as regards the regulation of markets (liberalisation of prices and of external trade) and measures concerning salaries and the labor market;

(b) medium term management of public resources;

(c) management of the parastatal sector;

(d) the development of agriculture and the forestry subsector;

(e) the transport sector.

Specific directions have been decided on and specific measures, together with a calendar of execution, have been identified for each of these areas.

THE STRUCTURAL ADJUSTMENT POLICY

6. The Government's structural adjustment policy is based on:

(a) the restoration of healthy competition throughout the economy;

(b) the deliberate support of agricultural producers;

(c) the suppression of certain regulatory constraints to development of the private sector; and finally,

(d) on concerted action in the labor market to obtain a reduction in (real) wages and salaries and maintenance of employment through greater labor mobility.

7. The thrust of this policy is to put pressure on wages and prices so as to obtain the effects of a real devaluation. It also tends, through differential action on salaries and prices, to shift the factors of production freed up from the non-tradeables sectors toward the productive, tradeables sectors. This is particularly so in the case of construction and civil works

Salaries and Structural Adjustment

8. The Government has concluded that the high level of costs in the Gabonese economy, be it because of salary levels or the high costs of services, is a serious impediment to competitiveness in the non-oil productive sector and to the reorientation of economic activity toward this sector. It is therefore necessary to bring pressure to bear on salaries overall.

9. The Government has already taken two significant measures which are leading to potential or real reductions in the cost of non-tradeable goods relative to tradeables:

(a) a 17% reduction in civil servants' salaries; and

(b) a very stiff reduction in investment expenditure from CFAF 450 billion in 1985 to less than CFAF 65 billion in 1987 1/ .

These measures form part of the program agreed with IMF. It is expected that the reduction in public investment will have a direct impact on the price of non-tradeable goods and lead to an overall decrease in demand. The most important effect of this measure on the real exchange rate will

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1/ The budget allocation if for 100 billion but the 37 million earmarked for OCTRA is essentially to cover arrears.

not become apparent unless the unemployment which it will create leads to a real drop in salaries.

10. A major concern of the authorities has been to reduce administrative and other obstacles limiting the impact of these measures on the economy, ns in particular the private sector. For this reason, the Government intends to implement the measures described below from three to twelve months after adoption of the program.

11. Parastatal Sector Payroll. The exceedingly high cost structure of the parastatal sector, sheltered from competition by high tariff (or natural) protection, represents a substantial burden for the remainder of the productive economy. In particular, the employment packages offered in the parastatal sector have a considerable negative impact on the labor market by creating high salary expectations and by siphoning off the best talent from the private sector. The Government therefore intends to enact salary cuts in this sector at least comparable to those made in the public sector and with the same progressivity. Specifically, the Government intends to:

(a) reduce the salaries and allowances of Presidents, Directors General, Assistant Directors General and of higher level staff in these enterprises to the extent that they are nominated by the Government. This will be done before adoption of the adjustment program. New salaries and fringe benefits will be fixed in accordance with benefits available in the public sector and with the degree of responsibility of the post in light of prevailing practices in the sector;

(b) within three months following the above reduction, require each parastatal to present a plan for reducing its payroll (including expatriates) so as to achieve a minimum of 4 percent reduction of all salaries and an average reduction (which may vary from company to company) of from 20 to 30 percent, according to salaries actually prevailing in a given enterprise. This reduction will be calculated on the basis of a constant number of national employees but may be achieved in the case of expatriates by diminishing their total number. After approval, these plans will be executed under the supervision of the Ministry of Finance.

12. Private Sector Salaries. It is expected that the generally reduced level of activity and the increase in unemployment resulting from cuts in the Investment Budget will cause the private sector to align itself with the public and parastatal sectors. However, these mechanisms may not be sufficient to bring about adequate reductions in salary levels of the private sector and to facilitate the transition, complementary measures will be needed:

(a) with regard to the trade regime (cf. below), the Government intends to liberalise customs regulations thereby creating

greater competition in the private sector and bringing pressure to bear on salary levels. The Government intends to use price control initially for the same ends.

(b) despite the lower cost of living in rural areas, a uniform minimum salary is applied nation-wide, with the result that marginal costs in the potentially most productive sectors are significantly higher than in neighbouring countries with which Gabon competes. The Government therefore intends to restore a minimum wage for agriculture (SMAG) which will be 25% lower than the urban wage (SMIG); no increase in either is foreseen for the near future.

(c) changes will be made to wage and labor legislation and regulations and to the ways in which they are applied in the first six months of the program to encourage:

(i) increased piece work;

(ii) stricter sanctions (loss of wages, suspension) against absenteeism ;

(iii) the suspension of the SMIG with respect to SMEs;

(iv) definition of statutes allowing apprentices to be paid at rates lower than the SMIG.

The Trade Regime, Price Controls and the Investment Code

13. The Government believes that the existing trade regime and investment code have been very favorable to both national and foreign companies through the creation and the maintenance of monopolies. While price controls have tended to depress investment in other countries, in Gabon, given the trade regime and the investment code, it has led to an excessively high level of effective protection and thereby to excessively high salary levels and a persistent use of expatriates.

14. For instance, most regimes of the investment code provide for an almost complete exemption from taxes, in particular for imports of intermediate consumer goods and for imports of investment goods which are subject to a "reduced rate" of 5%. In an environment of quantitative import restrictions this leads to an extremely high level of effective protection. The effect of these regimes is to discourage local production of intermediate and investment goods and to encourage capital-intensive production. The resulting protection, although theoretically limited in time, in fact can last for 20 years or more. Consequently, practically the

entire industrial sector 2/ benefits at a minimum from the UDEAC "taxe unique" regime. Indeed, the sector as a whole enjoys without time limit the kind of protection which normally reserved for infant industries. Because of this the Government foregoes considerable fiscal resources without the State's gaining any sort of compensating advantage.

15. Finally export duties and taxes, varying from 2% to 15% depending on the product, tend to work as a disincentive to exports. In view of these problems, the Government intends to modify over the coming months the whole private enterprise environment and incentive system.

16. The External Trade Regime. As outlined above, the Government intends to proceed as rapidly as possible with the elimination of quantitative import restrictions and to replace them with ad valorem tariffs. Of the 51 products which may only be imported upon receipt of a "certificat de carence", at least 30 will be subject to the new procedure outlined here within six months of the adoption of the program. The import of a further 16 products will be liberalised in the same way in the following twelve month period. Imports of the five remaining products will possibly be liberalised at a later date with possible exceptions being for sugar, vegetable oils and cement, given the unforeseeable fluctuations in their prices, the degree of protection which they enjoy in many countries and the limited small size of the Gabonese market.

17. Moreover, the levels of duties and taxes (taken together) should be revised in order to fix a ceiling of 100% for non-luxury items and 150% for luxury goods within six months of the adoption of the present program. These ceilings will be progressively reduced to 80% and 120% respectively over a three year period with a view to establishing a scale of customs duties around a "normal" or modal rate on the order of 60% 3/ and starting from a minimum rate of 20%. It is expected that this will bring about a significant reduction in the dissparity of effective rates of protection. Some gradually decreasing exemptions from these ceilings could be allowed for limited periods of time, particularly in the case of products previously subject to quota and for which Gabonese production enjoyed significant protection.

18. Export duties will be reduced, notably through exemptions from the export TCA (turnover tax), over a six month period following the adoption of the program. The government will look into the possibility of establishing, re-establishing or increasing import duties and taxes on meat, cereals and other foodstuffs not only to increase customs revenues and compensate for the reductions in such revenues outlined above but also

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2/ The forestry sector enjoys particular advantages.

3/ This should not be confused with an average rate. The usefulness of this rate will be studied and defined.

to stimulate food self-sufficiency, which is attainable in a certain areas, without, however, any abandonment of export agriculture. A minimum rate of 10% should be applied to these products within six months and the 20% minimum rate referred to above should be reached or even exceeded for most such products within 18 months.

19. Finally, to simulate the effects of a nominal devaluation, the Government will study the possibility of allocating the resources generated by this new import taxation (in particular that replacing import restrictions) to export subsidies for coffee, cocoa and wood where the shadow price of labor is significantly lower than that in the country generally. The Administration will proceed with several studies already under way to help put these measures into practice.

20. The Investment Code. The Government is aware of the perverse effects of the investment code and intends to draw up a new one on the following bases:

(a) gradual decrease over time of protection levels (elimination of the exemptions from import customs duties);

(b) increase of the "taux réduit (reduced rate) to at least the level of the domestic T.C.A. (8%);

(c) limitation of regimes to 10 years except for petroleum and mining products;

(d) definition of transitional steps from the old to new regimes;

(e) definition of an ongoing "taxe unique" (single tax) which would be less generous and result in fewer tax losses and more "fiscal".

The new code will be prepared within twelve months of program adoption. Any arrangements agreed in this period under the old dispensation will provide for automatic application of the new regime once adopted. The increase in the taux réduit will be put into effect in the six months following program adoption.

21. Price Control. While the Government is aware of the distortions which can be introduced into the economy through control of prices, it intends nevertheless to maintain existing arrangements for the time being with the following modifications:

(a) within six months of the adoption of the program the Government will bring margins on imported goods in line with those on comparable goods produced locally. In a number of cases, where the margin on local production is clearly inadequate, alignment will be made with reference to an intermediate point between the two presently authorised margins;

(b) in the case of products which are also produced locally, new customs duties should be set at levels such that competition will make control of their prices increasingly meaningless.

In any case, until the new tariffs are fixed at appropriate levels and in the clear absence of any competition, the present system of price control will be maintained. However, authorised margins will be reduced to reflect the desired drop in salaries (20 to 25%). This reduction will be put into effect within six months of program adoption.

22. Over the medium term, the Government will progressively dismantle controls on prices in keeping with the adjustments made in (ad valorem) import duties and taxes, except in cases where there is clearly no competition.

MEDIUM TERM MANAGEMENT OF PUBLIC RESOURCES

23. In conformity with the strategy defined above, the management of public finances should be based on mechanism which permits an evening out of budget resources and on the medium-term growth of stable resources generated by the non-oil sector. This management should focus on:

(a) a certain continuity in the overall evolution of public expenditures by major category;

(b) a break down by major function assuring:

  (i) a sustained effort in favor of investment in the productive sectors;

  (ii) rehabilitation and subsequently, appropriate maintenance of infrastructure necessary for development for the input supply and foodcrop marketing;

  (iii) improvement of public administration works;

  (iv) human resource development;

(c) with regard to investment expenditure, management by project or sub-project as opposed to management by line item in the context of a three year rolling investment program and under the effective control of the Ministry of the Planning and the Economy.

Stabilization of Budget Resources

24. The mechanism for stabilization of budget resources will allow the establishment and the viable implementation of the three year rolling investment plan in a country where a considerable proportion of Government revenue are notoriously unstable. It would complement the three year

rolling plan. The type of mechanism the Government is considering establishing progressively from 1988 on would have two components:

(a) the establishment of a certain number of rules for determining the Budget and Three Year Plan levels which should be determined in such a way that the rules are followed year by year; and

(b) the establishment of a mechanism which would permit stabilization of oil revenues allocated to the Budget (Reserve Fund).

A principal objective of the rules in question would be the maintenance of positive Government savings. Consequently, recurrent expenditure, that is, the sum of the Operating Budget and the interest component of debt service payments should always be less than 10% of stable resources, the latter being defined as the sum of the average of non-oil revenues over the three preceding years on the one hand, petroleum royalties calculated on the basis of a price of US$12 4/ and the projections for future production on the other.

25. The Government further intends to set up a mechanism to smooth petroleum revenue flows at times of high prices so that in times of crisis there will be sufficient reserves to maintain investment at adequate levels. This mechanism, which could work through a Petroleum Reserve Fund, would consist of freezing resources generated by any significant upward movement of petroleum revenues, that is to say that they would not be immediately available to the Budget, even for guaranteeing loans. The reserves thus created would be made available only to meet any sudden, sharp drop in Government revenues. This system would avoid situations where the Government exposes itself, at times of when its revenues are growing significantly, to investment programs which presuppose that such levels of revenues will continue for two, three or four years. It is important, therefore, within the context of the three year rolling plan, that the volume of investment commitments should always be covered and "insured" by securely foreseeable revenues 5/ and by sufficient reserves (Reserve Fund) which can be mobilized to compensate for unforeseen drops in oil revenue. This would be facilitated by the fact that revenue for the first year (except for royalties, which are in any case more stable) could be estimated with a fair degree of precision since they will be based on performance during the year in which the program is drawn up.

26. This arrangement would help to avoid sharp discontinuities in investments, that is to say, not only the sudden stoppage of programs or projects but also the inflation of the investment budget at times when

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4/ This price would be two or three dollars below the price at which the oil companies no longer generate taxable profits.

5/ That is to say, in the low-case scenario.

petroleum revenues are running high. Such a mechanism, which necessarily has implications for debt policy, might be designed according to experience gained in oil producing countries and with the management of stabilisation fund reserves. The Government intends to carry out a study based on this experience and establish a petroleum reserve fund appropriate to its own circumstances.

Programming of Expenditures

27. The Government considers that with scarcer and unstable public financial resources, more careful management of expenditure programming is called for. It therefore intends to establish, as soon as possible, a three year rolling Law-Plan system covering the entire range of public resources. Therefore, each year by end-September, the administration will prepare a draft loi-plan or Loi-Programme covering State activities for the following three years. This loi-plan will:

(a) define the general lines of economic and financial policy for the following three years;

(b) define the overall envelopes for the Investment and Recurrent Budgets and for debt service and will also specify financing policies for the period under consideration;

(c) continue a detailed program of public and parapublic sector investments, together with their financing, over the same period and would include any modifications necessary or likely in the light of new revenue projections;

(d) detail the accompanying measures needed and a calendar for their implementation;

(e) include the downstream consequences of the Investment Budget in the Operating Budget (i.e. recurrent costs).

This law will be presented by the Government to the National Assembly before the Loi de Finances which will, in fact, be its initial application. The first Loi-Plan will cover 1988-89-90 and will be prepared by September 1987. It will be in line with the requirements of the present program.

Management of the State's Investment Budget

28. It has become clear that the previous management of the public investment budget has led to anomalies arising from misunderstandings, abuses or oversights:

(a) abusive use of suppliers' credits has led to the launching of projects which were not originally in the budget in the belief that no formal expenditures were being undertaken and the promoters of which did not a consider that they had made any expenditure;

(b) the widespread idea that expenditures of borrowed resources do not somehow constitute part of the Budget has led to considerable budget overruns;

(c) the confusion between budget line item and project has led to credits earmarked for one particular phase of an activity being used to finance payments for start-up of a subsequent phase without the approval of the Ministry of Plan and of the Economy.

29. The Government is aware of this situation and and has already taken measures to address it. These include:

(a) the design, creation and implementation of an investment projects record system with the help of World Bank technical assistance. This will allow the integration of physical and financial data on projects at their different stages of preparation or execution;

(b) the establishment of the legal framework needed for strengthening the Ministry of Plan and of the Economy's monitoring and control capacities, in particular through entrusting it with the power to authorise investment expenses which will allow the information system to be kept up to date.

With this as a base, the Government further intends to:

(c) define a policy for the financing of investments within the framework of the agreements reached with the IMF, that is to say within the constraint of short and medium term financial equilibria;

(d) confirm the authority of the Ministry of Plan and of the Economy over execution of the Investment Budget and increase its monitoring capacity by stricter application of existing regulations and a clear division of the respective roles of the various actors involved;

(e) abstain for the present from use of suppliers' credits and, generally, from any extra-budgetary expenditure as agreed with the IMF;

(f) study in 1987-88 and put into service in 1989 a new management system and nomenclature for the Investment Budget which will be adapted to Gabonese institutional environment.

THE PARAPUBLIC SECTOR

30. The parapublic sector is comprised of some fifty companies in all sectors of the economy. Eight of these are industrial or commercial establishments, seven are State Enterprises and the rest are mixed economy enterprises or those in which the State has shares. They are characterised by high operating costs, heavy financial losses, low productivity and

inadequate management. The result is that the sector is an increasing burden on the State and has a negative impact on the competitiveness of the Gabonese economy because of the high cost of the goods and services it produces and because of the influence it exerts on salary levels.

31. The Government has already made some response to this situation by deciding to rationalise its activities in this sector through specific measures for closing, liquidating or privatising SONADECI, PIZO, SONAGAR, CODEV, SOGACCO, SOTRAVIL and SNBG. Beyond this, the Government intends to take overall action to reform and rehabilitate the sector according to a clearly defined strategy. Given the urgency involved, highest priority will be accorded to OCTRA. The principal lines of the government strategy will be as follows:

(a) the establishment of mechanisms to monitor the parastatal enterprises and of an institutional framework for State/Enterprise relations;

(b) a financial restructuring of the sector and introduction of rigorous financial discipline;

(c) rationalise the size of the sector on the basis of strict criteria for State intervention.;

(d) improve the economic and juridical environment in which the parastatal companies operate;

(e) revise the management, structure and statutes of companies in the parapublic sector with a view to reducing their operating costs and improving their competitiveness.

The execution of this policy will be led and monitored, as agreed with the IMF, by a Commission for Restructuring of the Parapublic Sector. This Commission will be technical in nature and will receive support from the Ministries of Finance, the Economy and Plan and the technical ministries involved.

Monitoring and Institutional Setting

32. The newly created Direction de la Programmation et de la Tutelle (Planning and Oversight) of the Ministry of Plan and of the Economy will within three months put into operation an information and monitoring system for the parapublic sector which will allow consolidated accounts to be established for 1984 and subsequent years and a management flow chart to be drawn up. The Ministry of Finance will immediately launch a program of parapublic sector accounting audits to be undertaken by international standard auditors. Each enterprise will deposit its financial statements for certification at the latest four months after closing its accounts at the latest.

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33. The company budgets, drawn up annually for the following financial year should be deposited with the Ministries of Finance and of Plan and of the Economy at the latest by September 30 so that its implications for the Budget with respect to operations, investment and variations in the guaranteed debt can be taken into account where necessary. An institutional study will be started within six months of the adoption of the program with a view to redefining the role of the various organisms of financial control in the sector, to clarifying the conditions under which the various oversight functions are to be exercised and to re-examine State/Enterprise relations so as to increase the degree of responsibility of the enterprises, set objectives more clearly and improve performance evaluation.

34. In this study, the following issues will be specifically addressed:

(a) the nomination of Boards of Directors;

(b) the nomination within each oversight ministry of a person to sit on the Board of Directors of a given enterprise and be specifically responsible for monitoring that enterprise;

(c) the nomination of an independent auditor;

(d) the nomination of company directors by the General Manager.

At the conclusion of this study, Laws 11/82 and 12/82, defining the statutes and oversight of parastatal companies will be modified put into immediate application. The texts concerning application will be produced and the statutes of the companies will be modified.

35. When the new legal and institutional environment has been established 18 months after adoption of the structural adjustment program and diagnostic studies (para XX) have been carried out, a contrat-plan system defining the relative responsibilities of the companies and the State will be initiated. The first companies affected could be OCTRA, OPT, SEEG, OPRAG and Air Gabon. The form of the contrat-plan or, where applicable, the management contract would depend on the juridical personality and economic nature chosen by the companies.

Restructuring and Financial Discipline

36. The Ministry of Finance will draw up a table of cross debts between the parapublic sector and the State, the parapublic sector and the banking system and among the parastatal enterprises themselves as agreed with the IMF. A plan will then be drawn up for settlement of the debts. Within three months of program adoption, all direct and indirect transfers and subsidies will be identified for each enterprise and for the sector as a whole and will be rolled back in accordance with the program agreed with the IMF. All investments by parastatal enterprises, whatever their source of financing - Government, guaranteed loan or retained earning - will be

subject to prior approval by the Government. Projects undertaken by parastatal enterprises will, in consequence, be included in the investment project record system by the Ministry of Plan and of the Economy during preparation of the Loi-Plan 1988-89-90. Within six months of program adoption, clear rules and conditions will be defined for State guarantee of debts. The ceilings for bank credit and the levels of effective outstanding amounts will be examined within four months and a six monthly system of review and monitoring established.

Rationalisation of the Size of the Sector

37. The Government considers that the parapublic sector has grown disproportionately large given the overall size of Gabon's economy. It therefore proposes to streamline the sector through the following measures:

(a) a five year moratorium on the creation of new enterprises with a possible exception being made for the case of replacing an existing structure;

(b) the immediate closing down of SOTRAVIL (already done), CODEV, PIZO, SNBG, SOGACCO and SONADECI, including the dismissal of their personnel;

(c) an official decision concerning liquidations will be followed by the nomination of liquidators. Clear judicial and administrative procedures will be defined to facilitate liquidations and privatisations; a privatisation-liquidation commission including the Ministries of Finance, of Plan and of the Economy and the technical ministries concerned will be created; the powers and role of the liquidators will be defined in an official text as will the modality of evaluating liquidation or privatisation costs; legal counsel, etc.

On the basis of previously defined criteria, the Government will elaborate a plan for streamlining the sector and classifying parastatal companies within six months of program adoption. The categories of classification will be: a) strategic companies to be maintained under a juridical form to be identified; b) non-strategic companies which are not viable economically and financially and which are to be liquidated; c) companies or agencies whose continued separate existence is not justified and which are to be absorbed by other companies or agencies or reintegrated into the public administration.

38. This classification will be based on technical, financial, economic, management and staffing diagnostic studies and on an analysis of the functions of the enterprise with respect to its cost to the public. The diagnostic studies will concern the enterprises listed in para XX. Once the classification exercise is completed, the Government will immediately begin:

(a) a search for potential private partners for enterprises to be privatised;

(b) the liquidation of non-viable enterprises;

(c) an examination of existing management or operating contracts (modalities, costs, expatriate personnel, tax exemptions);

(d) a program for the restructuring and rehabilitation of enterprises to be maintained (adequate juridical statutes, reorganization, staff reduction plans, cost reduction, etc.).

Improvement of the Economic Environment and Management

39. Within the context of its general policy on competition, prices and external trade with its tendency to reduce macroeconomic aggregates, the Government intends to take the following measures:

(a) a program of rate setting studies will be initiated in sectors where this has not already been done within six months. The objective will be to fix rates and prices at levels which do not result in excessive cost structures at the expense of the consumer and other sectors but which at the same time do not penalise the enterprise by fixing tariff rates which are too rigid or too low without compensation;

(b) procurement procedures will be revised within twelve months with a view to achieving greater technical and financial efficiency.

Improvement of Management and Rehabilitation

40. The Government intends to operate at two levels in this area: personnel management and wage policy, and technical and financial management. With regard to the first, Government intends to:

(a) place an immediate freeze on personnel numbers;

(b) execute a plan for the reduction of superfluous staff where applicable within twelve months of the results of the diagnostic study of each enterprise;

(c) make a detailed examination of the levels and costs of technical assistance and of programs for Gabonisation;

(d) take urgent salary reduction measures as outlined in para XX;

(e) following these measures, and possibly within the context of the contrat-plans, study a new personnel management policy with a view to basing recruitment, employment status, promotion and salaries on competence and merit.

41. With respect to technical and financial management, in-depth diagnoses will be carried out for OCTRA (as a matter of urgency), OPT, SEEG, Air Gabon and SNTH. They will include management and financial audits as well as technical audits where necessary. Programs will be drawn up for the rehabilitation of these companies and measures concerning statutes, organization and financial and technical issues defined. The implementation of these recommendations will be automatically started under a calendar to be agreed between the Government and the enterprise concerned. On this basis, the contrat-plans will be finalised so as to clarify the relationship between the Government and the enterprise and particularly to define ways and criteria for deciding possible subsidies.

SECTORAL POLICIES

42. The Government considers that, with the exception of SMEs, its policy of giving priority to the productive sector should focus on development of the rural sector, agriculture, forestry and the timber sector as well as on the related area of transport.

Agriculture

43. Agriculture should clearly be the principal focus of the Government's new policy of giving priority to the productive sector. Despite numerous expressions of intention to develop this sector in the past, Gabon's agriculture suffers from a number of institutional and structural constraints arising in large part from lack of investments, a macroeconomic environment common to many oil-producers and finally, from natural factors particular to Gabon. Among the most notable are:

(a) a relatively low, widely scattered and aging rural population which, combined with the difficulty of building and maintaining a road network in a situation where resources are scarce, makes input supply and marketing a difficult and costly proposition;

(b) the rural out-migration which has been accelerated by vast infrastructure projects and the rapid economic development of the urban areas, all of which have led to shifts in dietary habits;

(c) the general rise in prices and salaries which has penalized agriculture by making services such as transport and marketing more costly, raising the operating costs of agro-industrial production units and consequently reducing their international competitiveness;

(d) finally, despite the proclaimed objectives of the Fifth Plan and with the exception of the Integrated Operational Zone concept (OZI), the guidelines for development of the sector have never been really applied. The result has been the dissipation of effort, great weakness in the research, extension, production process and , with the exception of the agro-industrial combines,

severe inadequacy of the organizations responsible for running Gabon's agriculture.

It is quite clear that under present conditions the agricultural sector will be quite incapable of making up in any way for the loss of revenue from the oil sector or even for the loss of activity due to cuts in Government expenditure.

44. Prices and Marketing. The marketing of agricultural products presents serious problems. There is little or no institutional support for produce collection and the Stabilisation Funds, even though they have kept prices for cocoa and coffee comparable to those paid in neighboring countries, have been unable keep pace with the increase in salary levels: by comparison with 1973, the price of cocoa relative to the SMIG has fallen by 42%. Prices for local foodstuffs are nominally fixed by the Provincial authorities for a number of products through the "mercuriales". They do not take serious account of production costs and are generally below market prices. While applied only sporadically, they undoubtedly have a disincentive effect particularly in the context of organised projects. The Government intends therefore to abolish the "mercuriales" completely and to take with effect immediately.

45. The marketing costs to the final urban consumer are usually two to three times the price received by the producer. These margins are well above any found in comparable circumstances elsewhere in Africa. Even if some of this discrepancy can be attributed to the dispersion and low density of the population and the poor state of the road network, an in-depth study seems necessary to identify the roots of the problem. Such a study should concentrate on the possibilities of Provincial authorities creating and assisting marketing cooperatives, establishing storage facilities in rural or urban areas, or disseminating market information. In no event, however, will the State intervene directly in marketing activities.

46. The cocoa and coffee Stabilisation Funds should be merged. They have monopolies on the purchase and handling of their respective crops but the total volumes involved are small despite even tonnage originating in Equatorial Guinea. Unit costs are high, particularly in the case of coffee partly because of under utilised shelling facilities. It is therefore proposed that the Stabilisation Funds withdraw progressively from crop handling and farmgate purchase and limit their role to the guaranteeing of fixed prices. This withdrawal would be accomplished in two phases:

(a) for the 1987/88 crop year, buyers authorised in keeping with objective criteria would be allowed to intervene freely in specified areas and within a range of prices fixed by the Authorities;

(b) for 1988/89, the Stabilisation funds would withdraw totally from crop handling, except possibly for export in the strict sense if the low volumes involved necessitate this.

47. Agro-Industrial Projects. The return on certain agro-industrial projects has been less than expected because of the fall in commodity prices and of the dollar and because of higher structural costs than anticipated. The Government nevertheless believes that they are a major element of its strategy to reorient the economy toward the productive sector. Indeed, the Government intends to use them and the OZI as development poles for the promotion of private agriculture. This has already been at Ndende (livestock) and is proposed for HEVEGAB (para. XX). The Government believes that although the management of HEVEGAB and AGROGABON is satisfactory, their costs should be brought down. Specifically, this would take place following application of the new SMAG (25% lower than the SMIG) and in light of the fact that these two enterprises will also be affected by the lowering of salaries in the parapublic sector.

48. Similarly, the Government has recently decided that imports of vegetable oil will be forbidden and that vegetable oil producing and refining (AGROGABON) will be merged with bottling (SEPOGA). This measure was taken in the light of the availability of marketable amounts of refined vegetable oil are in line with domestic consumption. This production will substitute for subsidised imports of vegetable oil which are marketed, after bottling, by SEPOGA. Subsidies will probably still be needed for export of surplus oil as plantations reach maturity and more raw and refined oil is produced. Theses future levels of production will be adjusted according to prevailing international prices at that time and of in light of variable costs incurred.

49. Agro-Industry and Private Initiative. Prevailing conditions in the rural areas are the rationale for the Government's intention to make agro-industrial estates a main element of its agricultural policy. However, only a limited number of workers are employed in agro-industry. For this reason, the Government has decided to expand the activities of the agro-industrial estates to include support for local private initiative, particularly of medium-scale undertakings (100 - 300 ha). This, for example, could be through the support of cooperatives or through use of existing structures to deliver services to a target population. Services would include a certain amount of extension, collective purchases of inputs, equipment repair and maintenance, some administrative services and assistance with marketing. Beneficiaries of these services would contribute to their cost. In cases where the service would normally have been provided by the Government, it will continue to meet their cost within the context of the contract-plans. The Government will undertake a feasibility study of this scheme as soon as possible as part of the elaboration of the new guidelines (Schema Directeur) for agriculture.

50. Village Agriculture. With regard to cocoa and coffee production, the Government has recently decided to liquidate SONADECI since it has proven too costly and inefficient to justify. With this experience in mind, the Government intends with private assistance, to create a new, lighter structure, SOCAGAB, whose operations will initially be limited to 650 ha of cocoa and coffee. To avoid the pitfalls of the past, the

Government intends to fix norms for operating and investment costs in the contract-plan with SOCAGAB. SOCAGAB will be able to export directly.

51. In line with the services to be provided by the agro-industrial complexes, SOCAGAB will also be expected to provide technical assistance to small and medium scale holdings through facilitating input purchase, marketing and access to credit. Any extra cost incurred for these services would be covered under the provisions of the contrat-plan.

52. Institutional Reform. Although the Government is convinced its proposed policies with respect to use of the agro-industrial complexes is correct, it must be admitted that only a small part of the rural population will be affected and that relatively little has been obtained from research and extension hitherto. With 1320 rural dwellers per extension agent, Gabon is well below the international norms for counties with scattered populations which are currently about one agent per 300 rural dwellers. Research and development activities have been limited and poorly organised. For instance, CIAM (Center for Plant Introduction, Adaptation and Multiplication) supplies selected plant material to the OZI, which represent only 5 to 10% of farmers, and to the CPRs (Centres de Promotion Rurale) which are engaged in research on cultural methods and types of holdings, and have little or no direct contact with producers.

53. The results have been very limited and the research which has been done has not been undertaken with any real concern for the financial viability of proposed techniques. This has limited the extent to which they could be replicated. And even if this type of research did give replicable results, it would be difficult to extend them to smallholders because of the lack of agents. The problem is compounded by the scarcity of appropriately qualified and experienced staff in the Ministry of agriculture and the great reluctance of such staff to serve in the rural areas. The Government has therefore decided:

(a) to define precise norms of economic and financial viability for research done by the OZI and CPR and to study ways of strengthening the links between the different stages of research;

(b) study the possibilities for mechanised agriculture in Gabon, given the high cost of labor;

(c) earmark resources for the recruitment and training of extension personnel with a particular emphasis on adapting the programs to the real needs of Gabon (bureaucracy excluded);

(d) insist on rotation of Ministry of agriculture personnel and make field service a prerequisite for career service with this Ministry.

The above points should be the key elements of the new guidelines for agriculture which will be prepared in time to be ready for operation 18 months after the adoption of the present program.

Forestry

54. Present wood production in Gabon is 1.3 million m3 per year. This could probably be doubled without danger to forest resources. Given that domestic demand is falling, this would lead to more than a doubling of exports. But this objective is difficult to attain, among others because of the appreciation of the CFA franc relative to the dollar and the 43% depreciation of Indonesia's exchange rate: Indonesia is one of Gabon's principal competitors in tropical woods. As outlined above, the Government intends to take measures which will be equivalent to devaluation in real terms through general cuts in salaries, including salaries in this sector. However, the Government considers that there are other constraints which also which impede the development of wood exports:

(a) the very high levies charged by SNBG (16% of the "core price" plus the DTS margin) for which a capital increase to be financed partly by increased payments from foresters is proposed in 1988 - a further burden on the profitability of forestry;

(b) OCTRA's prices which may be as much as 50% of the "core price" and which have been upped by 20% over the last two years;

(c) export duties and taxes of 10 to 15%;

(d) slow processing of imported spare parts which are entitled to a reduced tax rate (less than a third of such imports actually benefit from this concession to which they are entitled);

(i) high ocean freight rates.

The Government intends to liquidate SNBG within three months of program adoption, given its high charges, its subsidy needs and the almost unanimous opposition to it from the forestry sector.

55. At the same time, the Government intends to set up a task force on forestry under the aegis of the Commission on Economic Management. It would include representatives of the Ministry of Forests and Waters, OCTRA, and foresters. The task force's responsibilities would be to:

(a) evaluate the impact on the marginal costs of wood transport of the reduction in OCTRA's salary, structural, and purchase of goods and services costs.

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(a) evaluate the impact on the marginal costs of wood transport of the reduction in OCTRA's salary, structural, and purchase of goods and services costs.

(b) adjust freight rates in the light of those practiced in Cameroon, Côte d'Ivoire and elsewhere so as to give Gabon's a better basis for competition; subsidies could possibly also be considered 6/ ;

(c) examine ways to handle import exoneration requests for forestry spare parts much more expeditiously;

(d) evaluate measures needed to develop the wood industry; and

(e) draw up guidelines (Schema Directeur) for forestry use and the wood industry. These should be based on the measures outlined above and the need to conserve and regenerate the nation's forestry assets and should be geared to doubling the volume of wood exports (including processed wood) over seven years.

The Transport Sector

56. For a decade the Government made large investments in transport infrastructure, principally railroads and airports, before considerably decelerating these projects in 1986. In the same period, infrastructure maintenance grew progressively weaker and ceased for all practical purposes at the local level. More generally, investments were aimed not at multi-modal development of the sector as a whole but at the development of the railroad and the air network only. The result is a deficiency of investment in and maintenance of roads.

57. The 1978 and 1982 national transport plans requested by the Ministry of Transports were never put into effect and investments were generally made without any economic evaluation having been made. Moreover, transport tariffs are decided by each of the transport organisations with no national coordination. Within the context of the structural adjustment process, it is opportune to re-establish a coherent plan for State intervention so as to support Government's efforts to increase the profitability of investments in wood and agriculture and to diminish the costs of building and maintaining a transport infrastructure. The two national plans will be updated over a period of a few months without any new expense for studies being incurred. The updated transport plan will be put into execution by Government decision and its implementation carefully monitored.

58. On this basis, and without anticipating the content of the updated national transport plan, the Government has already decided on the major orientations it wishes to pursue. These have been chosen in the

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6/ These could be financed (a) by the resources otherwise used to subsidize SNBG; or (b) the tariff revenues available from the conversion of QRs into ad valorem tariffs.

light of the present situation and of the results of previous studies and are as follows:

(a) rehabilitation of road and river/marine infrastructure wherever sufficient transport demand exists;

(b) structural reorganisation of road maintenance and resumption of road maintenance work in line with the updated study on road maintenance and according to a timetable to be established;

(c) adaptation of airports and aircraft to Gabon's real air transport needs;

(d) maintenance of the railroad service, under a restructured operating agency, only for profitable or socially essential services;

(e) containment of new infrastructure within the limits of real needs and resources available and only after satisfactory feasibility studies;

(f) research on ways to improve returns from existing infrastructure through means of a multi-modal policy and if necessary of disinvestment from one competing mode on a given route;

(g) systematic research into the reduction of construction and maintenance costs through a study of unit costs and a consistent use of bidding procedures;

(h) reorganisation of the road transport profession through the revision of administrative, judicial and fiscal arrangements and through a policy of incentives and training;

(i) reinforcement of the Ministry of Transport's planning capacity and increased collaboration with the Ministry of Public Works;

(j) technical and financial audits of the transport organisms under ministerial oversight and tighter control over their management and objectives through contrat-plans; and

(k) definition of a transport tariff policy as part of the Government's pricing policy and clarification of the services or sorts of transport which should be subsidised, possibly through means of the contrat-plan.

PART III - MANAGEMENT OF THE ADJUSTMENT PROGRAM

Proposals for Monitoring Implementation

59. The Government has created an Inter-Ministerial body to steer, coordinate, and monitor the adjustment program. This body, the "Commission for Economic Management and Reorganisation" is chaired by the Prime Minister. Its orienting committee comprises the Prime Minister, the Ministers of Plan and the Economy and of Finance, the High Commissioner for the Plan and the Economic and Financial Adviser of the Head of State. These High Commissioner and the Presidential Adviser head the Commission's technical arm, the Permanent Technical Committee (CTP) which is composed of Directors, Directors General and Experts working in the Administration.

60. The Commission, through the CTP, will ensure that proposed measures are mutually compatible and will oversee their implementation. It will also promote the establishment, and perhaps design, responsive information systems to monitor all aspects of management of the agreements concluded with the IMF and measures called for under the adjustment program.

61. In this capacity it will be the principal interlocutor of the World Bank, the IMF and, in principle, other organisations which may become involved in design and implementation of Gabon's economic policy. It will monitor the effects of Structural Adjustment Program measures and generally oversee the fulfillment of Gabon's undertakings, reporting to the Authorities. In concert with the services concerned, it will prepare documentation relating to the implementation of program measures for examination by IMF and World Bank missions. Finally, it will make recommendations with respect to modifications which may become necessary for satisfactory program implementation.

62. To help it carry out its mandate, the CTP and the Commission will be able to call on the services of other committees, commissions and task forces such as those dealing with specific technical areas in the parapublic sector, agriculture, forests and waters, finance and the like.

G A B O N

Policy Matrix -- Structural Adjustment Program

POLICY OBJECTIVE	NO	MEASURES TO BE TAKEN BY GOVERNMENT	MONITORABLE ACTIONS	TIMING	OBSERVATIONS	RELATED & FOLLOW UP ACTIONS
To exert downward pressure on wages and on the cost of services.	1	45% cut in civil service indemnities	Decree.	DONE	Also in IMF Standby.	
	2	12% cut in indexed civil service wages.	Decree. Board condition.	Jan 1988	Also in IMF Standby.	
Measures geared to re-align real exchange rate and increase labor mobility.	3	10% cut in SMIG.	Decree. Board condition.	Jan 1988	May be instituted late 1987.	
	4	Cut Investment Budget to CFAF 91.5bn in 1987, 70 bn in 1988.	1987 Investment Budget. 1988 Investment Budget.	DONE	Also in IMF Standby. Also in IMF Standby.	
	5	Cut top parastatal salaries.	Decree. Board condition.	Mar 1988	To be aligned with comparable public sector positions.	Ministerial and Sub-ministerial positions to be benchmarks.
	6	PEs present payroll reduction plans.		Aug 1988	To be executed by PEs in tandem with Plan, Finances.	
	7	10% across the board reductions.		DONE		
	8	Create SMAG 25%> SMIG.	Decree. 2nd Tranche cond.	Aug 1988	To reflect lower rural living cost	
	9	Establish mechanisms to increase labor mobility.	Legislative texts on piece work, sanctions against absenteeism, apprenticeship programs.	Nov 1988		
	10	Suspend SMIG for SMEs.	Decree. 2nd Tranche cond.	Nov 1988		
To eliminate quantitative restrictions on imports and to encourage domestic competition and exports.	11	Sustitute ad valorem tariffs for QRs (certificats de carence) and introduce provisional surtax.	Text abolishing QR's, and setting surtax levels and calendar for progressive surtax elimination. 2nd Tranche condition.	Nov 1988	51 products in all are subject to "certificat de carence" rule; the authorities strongly believe that sugar, cement, and palm-oil will continue to need special protection and may desire to conserve QRs.	To be researched and monitored by Comite Permanent Technique (CPT) and Bank missions in the field.
	12	Revise and harmonize customs code.	Text setting provisional maxima of 100% non-luxury and 150% on luxury goods. 2nd Tranche cond.	Aug 1988	Progressive reduction of average + maximun tariffs needed. Target levels + calendar to achieve these levels yet to be determined.	
	13	Fix minimum import duties on rice.	10% - 20% minimum.	Nov 1988	To encourage local food production	
	14	Fix minimum import duties on meat.	10% - 20% minimum.	Nov 1989		
	15	Eliminate droits de sortie on exports.		Nov 1988	Would affect primarily timber.	
	16	Introduce import tax - export subsidy scheme.	Decree. 2nd Tranche cond.	Nov 1988	Tax/subsidy rate and index for estimating future rates yet to be determined.	

POLICY [illegible]VE	NO	MEASURES TO BE TAKEN BY GOVERNMENT	MONITORABLE ACTIONS	TIMING	OBSERVATIONS	RELATED & FOLLOW UP ACTIONS
Increase efficiency, reduce fiscal cost of Investment Code.	17	Reduce levels and disparity of effective protection.	Remove duty free treatment on imports of intermediates, Raise taux reduit on capital goods imports to 8% (TCA) or higher, except for exports.	Nov 1988	[illegible] of Investment Code revision.	
	18	Reduce duration of protection under Investment Code.	Limit Inv. Code regimes to 10 years.	May 1989	Will have retroactive effect on agreements made during transition. Part of Investment Code revision.	
Modify existing price controls.	19	Align margins on imports with those on comparable locally produced goods.	Legal text.	Aug 1988	Where margin on local goods is clearly inadequate, alignment to a notional midpoint.	
	20	Reduce margins on domestically produced goods in keeping with cuts in salaries.	Legal text.	Aug 1988		
	21	Fix customs tariffs on imports in direct competition with local goods at levels which render price control increasingly meaningless.	Legal text.	Nov 1988		Periodic adjustment (six monthly).
The reform and streamlining of the parastatal sector and the elaboration of a long term strategy for improved organization, management, and for financial discipline in the future.	22	Establish the Commission for Parapublic Sector Reorganization.	Nomination of members, allocation resources for technical structure.	Mar 1988	Also in IMF Standby.	Under aegis of Commission de Gestion de l'Economie.
	23	OCTRA Audit.	Board condition.	Mar 1988	See SAL-Related Studies attachment	
	24	Privatisation/liquidation of CODEV, SONADECI, SONAGAR, PIZO, SOGACCO, SOTRAVIL and SNBG.	Closing of premises, firing of staff, hiring of liquidators, search for partners. Liquidation SNBG + SONADECI Board condition.	Mar 1988	Agreed with IMF for 5 (SONADECI, SNBG not included). Measures must be irreversibly advanced.	
	25	Freeze on staffing levels.	Payroll figures.	Mar 1988	Also in IMF Standby.	Monthly monitoring.
	26	Identification sector cross debts and plan for settlement.	Agreement of figures, dates for repayment.	Mar 1988		
	27	Select enterprises for rehab'tation, liquidation, privatization.	Production of list for action.	Aug 1988		
	28	Diagnostic studies OCTRA, OPT, Air Gabon, SEEG and OPRAG.	First step toward sector wide audit.	May 1989	See SAL-Related Studies attachment	Should represent model for sector-wide work.
	29	Start sector-wide audit program.	Financial statements, extended reports. Planning, preparation to begin with program adoption.	Mar 1988	See SAL-Related Studies attachment	Should provide sufficient info. to draw up rehab. program.

POLICY VE	NO	MEASURES TO BE TAKEN BY GOVERNMENT	MONITORABLE ACTIONS	TIMING	OBSERVATIONS	RELATED & FOLLOW UP ACTIONS
Effective sector monitoring.	30	Identify subsidies & transfers.		Aug 1988		Ministry of Finance.
	31	Put monitoring system in operation.	Information matrix to cover requisite data.	Aug 1988	Obtain agreement on nature of information to be provided.	
Redefinition of Company/State relationship, oversight roles.	32	Study Juridical and Institutional setting of sector.		Nov 1988	See SAL-Related Studies attachment	
	33	Parastatals' rehabilitation plans.		May 1989	For those remaining in public portfolio.	
	34	Contrat-plans.	Drawn up in tandem with rehabilitation plans.	May 1989		
	35	Adoption sector wide financial rationalization plan.		Nov 1988		
	36	Manpower reduction plans.	Plans to be produced by PEs.	Nov 1988		Establishment of computerised MIS.
State review of all new parastatal investment.	37	Integrate sector investments in Loi-Plan.	National Budget.	1988		
	38	Review credit ceilings for sector.		Sept 1988		
Rationalise sector size.	39	5 year moratorium on new enterprises	Board condition.	Mar 1988	Exceptions for replacement only.	Periodic monitoring.
Improve sector economic management.	40	Review procurement procedures.	Draft new procedures.	May 1989	See SAL related studies attachment	
	41	Review cost of t.a.		May 1989	See SAL related studies attachment	
	42	Devise programs for Gabonisation.		May 1989	See SAL related studies attachment	
	43	New sector management policies.		May 1989	See SAL related studies attachment	
	44	Application of new institutional arrangements.		Nov 1989		
Medium term mangement of the State's resources.	45	Rational forward planning of budget and investment levels.	Production 3 Year Loi-Plan. Loi-Plan for 1988 Board condition.	YEARLY Mar 1988	Also in IMF Standby.	
	46	Loi Finances 1988.		Sep 87	First application of Loi-Plan.	
	47	Define investment financing policy.	Establishment oil reserve fund. 2nd Tranche cond.	July 1988	Within limits agreed with IMF.	

POLICY OBJECTIVE	NO	MEASURES TO BE TAKEN BY GOVERNMENT	MONITORABLE ACTIONS	TIMING	OBSERVATIONS	RELATED & FOLLOW UP ACTIONS
Improve budget management.	48	Strengthen Plan monitoring capacity.	Legal texts empowering Plan to authorise investments.	Aug 1988		
			Clear definitions of roles of various actors.	Aug 1988		
	49	Stop extra-budgetary expenditure.	No use of suppliers' credit.	Mar 1988	As agreed with IMF.	
	50	Study new management system and nomenclature.		May 1989	See SAL-Related Studies attachment	
Shift priority to development of productive non-oil sectors, i.e. the development of agriculture and forestry and improvement of rural and other infrastructure.	51	Elimination of mercuriales.	Legal text. Board cond.	Mar 1988		Research and monitoring on-site.
	52	Improve crop collection, marketing.	Study in context of Agricltl sector memo.	Aug 1988	See SAL-Related Studies attachment	
	53	Establish expanded nucleus estates from agro-industrial blocks consolidation.	Study in context of Agricltl sector memo.	end 1987		
	54	Withdrawal of Stabilisation Funds' monopoly of coffee and cocoa marketing.		end 1988	Eventual role to guarantee floor price for coffee and cocoa.	
	55	Establish SOCACAB.	Reach agreement.	?	This will be a scaled down version	
	56	Improve research and extension .	Define practical norms for DZI and CPR research.	?	Work would probably be combined with marketing project.	
			Recruit and train agents.	?		
			Rotation of Min Ag staff to field assignments.	?		
	57	Prepare new guidelines agriculture.		Nov 1989	To be coordinated with AF1AG staff	
Increase exports of wood.	58	Double present wood production.	Form forestry task force . Board condition.	Mar 1988	Under Econ. Management Commission.	
Improve roads and road maintenance in support of rural sector.	59	Define and adopt new national transport plan.	Update 1978 and 1982 plans.	Aug 1988	To be done without further cost for studies.	

POLICY ‾VE	NO	MEASURES TO BE TAKEN BY GOVERNMENT	MONITORABLE ACTIONS	TIMING	OBSERVATIONS	RELATED & FOLLOW UP ACTIONS
Managemen the Adjustment Program	60	Make Economic Management Commission operational.	Define mandate, allocation of resources. Board cond.	Mar 1988	Crucial, sensitive and urgent. Assistance and close monitoring desirable.	Definition mechanisms, procedures for "hands on" monitoring Establishment/strengthening of informations systems economy-wide.

PARASTATAL STUDIES

	NAME OF STUDY	DESCRIPTION OF STUDY
1.	STUDY OF LEGAL AND INSTITUTIONAL SETTING OF SECTOR	TO REDEFINE THE ROLE OF VARIOUS KEY COMPANIES IN THE SECTOR AND REEXAMINE THE RELATIONSHIP BETWEEN STATE/COMPANIES.
2.	PERSONNEL MANAGEMENT STUDY	TO ESTABLISH A PERSONNEL MANAGEMENT SYSTEM BASED ON COMPETENCE AND MERIT.
3.	OCTRA AUDIT	TO IDENTIFY AND EVALUATE COST REDUCING MEASURES.
4.	DIAGNOSTIC STUDIES (OCTRA, AIR GABON, OPT, OPRAG, SEEG)	REVIEW ACCOUNTING, FINANCIAL AND MANAGEMENT SYSTEMS AND TECHNICAL CAPABILITIES WHERE WARRANTED.
5.	TARIFF STUDIES	TO SET NEW PRICES.

GENERAL STUDIES

	NAME OF STUDY	DESCRIPTION OF STUDY
1.	NEW MANAGEMENT SYSTEM AND NOMENCLATURE	TO PREPARE AND IMPLEMENT A SYSTEM AND NOMENCLATURE FOR INVESTMENT BUDGET MANAGEMENT.
	CROP MARKETING STUDY	TO REVIEW INCENTIVES AND TO ASSIST IN THE SET UP OF MARKETING COOPERATIVES.
3.	AGRICULTURAL MECHANIZATION	TO EXAMINE THE MECHANIZATION POTENTIAL OF GABONESE AGRICULTURE.
4.	FONDS DE RESERVE	TO REVIEW THE EXPERIENCE OF OIL-PRODUCING COUNTRIES IN MANAGING A STABILIZATION FUND.
5.	ROADS STUDY	TO REORGANIZE THE STRUCTURE OF THE ROAD MAINTENANCE SYSTEM.
6.	FEASIBILITY STUDY	TO LIMIT THE BUILDING OF NEW INFRASTRUCTURE BASED ON ACTUAL NEED AND AVAILABLE RESOURCES.
7.	TRANSPORT COSTS	TO REDUCE ROADS CONSTRUCTION AND MAINTENANCE COSTS.

AF1CO
September 1987

TIMETABLE: SAL I

CORE STEPS	DATE
Preappraisal Mission	02/27/87 A
Initial IM	04/17/87 A
EPS/IM to LC	09/30/87
Appraisal Departure	10/15/87
Yellow Cover	12/15/87
Docs to RVP/LC	01/15/88
Negotiations	02/15/88
Board Approval	04/01/88

GABON

KEY SAL CONDITIONS

A. BOARD CONDITIONS

1. * cut in indexed civil service wages to result in a 10% decline in the wagebill.
2. 10% cut in SMIG
3. * Cut top parastatal salaries
4. Complete OCTRA audit
5. * 5-year moratorium on new public enterprises
6. Elimination of mercuriales
7. * Establishment of Economic Management Commission
8. * Liquidation SONADECI and SNBG
9. * Prepare Loi Program for 1988 (three year investment program)
10. Form Forestry Task Force

B. SECOND TRANCHE CONDITIONS

1. * Create SMAG 25% less than SMIG
2. Suspend SMIG for SMEs
3. Introduce Import tax - Export Subsidy Scheme
4. * Revise and harmonize Customs Code
5. * Substitute <u>ad valorem</u> tariffs for QRs (Certificats de carence) and introduce provisional surtax
6. * Establishment of Oil Reserve Fund

NOTE: This list has yet to be discussed with Government, and we do not expect the Government to fully agree to this very ambitious reform package. An asterisk indicates priority measures, and clear progress in these areas is required.

Gabon: Base Case Scenario

Key Assumptions

	growth rates 1986-88	growth rates 1988-92	growth rates 1992-95
(A) GDP (growth rate)	-8.7	2.6	0.4
(B) Non Oil Exports			
Forestry	4.8	9.2	7.5
Manganese	5.3	5.3	3.0
Uranium	0.5	1.0	1.0
Total GNFS	2.8	6.5	6.3
(C) Non Oil Value Added			
Non-Tradeables	-25.2	0.9	2.8
Tradeables	-4.8	4.4	5.5
Total	-16.4	2.6	4.3

	1986	1987	1988	1990	1992	1995
Oil Sector						
Price FOB ($/bb)	12.5	15.0	16.9	16.9	19.2	23.6
Production (million MT)	8.3	7.8	8.2	8.8	9.4	8.5
Balance of Payments						
TOT (1984=100)	47	52	55	55	61	68
Public Drawings MLT Debt (million US$)	456	292	200	155	182	248

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Merchandise Exports	2039	1873	1058	1208	1380	1453	1529	1681	1860	1973	2057	2179
o/w Oil	1710	1545	689	801	944	980	1016	1123	1239	1291	1303	1345
Non-Oil	329	329	368	407	436	472	513	557	620	682	754	833
Merchandise Imports (CIF)	-888	-1045	-1109	-743	-736	-741	-770	-763	-824	-840	-914	-989
o/w Oil	-165	-176	-174	-197	-211	-216	-220	-214	-230	-221	-224	-230
Non-Oil	-723	-869	-934	-546	-525	-525	-550	-549	-594	-620	-690	-760
TRADE BALANCE	1151	828	-51	465	644	712	759	917	1036	1133	1143	1189
o/w Oil	1545	1369	515	603	733	764	797	909	1009	1070	1079	1116
Non-Oil	-394	-540	-566	-138	-89	-52	-37	8	26	63	64	73
Non-Factor Services Exports	108	129	129	123	131	143	152	152	168	174	195	216
o/w Oil	41	38	28	26	30	37	40	40	46	49	54	60
Non-Oil	66	91	101	97	101	106	112	112	122	126	141	156
Non-Factor Services Imports	-861	-790	-655	-730	-845	-848	-809	-763	-815	-819	-884	-939
o/w Oil	-558	-507	-348	-508	-620	-622	-575	-535	-566	-565	-602	-630
Non-Oil	-303	-283	-307	-222	-225	-226	-233	-228	-249	-253	-282	-310
RESOURCE BALANCE	398	167	-577	-143	-69	6	103	306	389	489	455	465
o/w Oil	1028	899	196	121	144	179	261	415	490	553	532	546
Non-Oil	-630	-732	-773	-264	-213	-173	-158	-108	-101	-65	-77	-81
Factor Services Receipts	48	29	29	13	11	16	20	22	21	18	22	25
o/w Oil	16	11	12	7	10	13	17	18	18	17	19	21
Non-Oil	32	18	16	6	1	2	4	3	2	1	3	5
Factor Services Payments	-247	-243	-268	-206	-270	-366	-362	-348	-359	-356	-359	-366
o/w Oil	-144	-131	-133	-99	-119	-137	-147	-146	-150	-146	-149	-153
Profits	-110	-93	-81	-33	-39	-39	-37	-42	-46	-50	-51	-53
Interest	-34	-38	-52	-66	-80	-98	-110	-105	-104	-96	-98	-100
Non-Oil	-103	-112	-136	-107	-151	-229	-215	-202	-209	-210	-210	-214
Profits	-32	-47	-45	-38	-35	-33	-34	-34	-38	-41	-46	-53
Int. Non-Guar. Private	-14	-13	-17	-23	-27	-18	-15	-15	-13	-13	-14	-14
Int. Public & Guar. Priv	-58	-52	-73	-40	-82	-171	-158	-141	-136	-127	-119	-113
Int. Gap	0	0	0	0	0	0	0	-8	-22	-29	-31	-33
Int. IMF	0	0	0	-7	-7	-7	-7	-3	0	0	0	0
GOODS & SERVICES BALANCE	199	-47	-817	-336	-329	-344	-238	-20	51	151	118	124
o/w Oil	900	779	75	29	34	55	131	287	358	424	402	414
Non-Oil	-701	-826	-892	-365	-363	-399	-369	-307	-307	-273	-284	-290
Current Transfers (net)	-66	-96	-139	-92	-65	-51	-51	-53	-61	-68	-76	-89
o/w Oil	-32	-31	-35	-34	-34	-33	-34	-33	-37	-38	-38	-41
Non-Oil	-34	-65	-103	-57	-31	-18	-17	-20	-25	-30	-38	-48
Private (net)	-60	-78	-118	-80	-58	-58	-61	-63	-71	-75	-86	-99
Public (net)	25	13	14	23	27	40	43	43	46	45	48	51
CURRENT ACCOUNT BALANCE	132	-143	-956	-428	-394	-395	-289	-73	-10	83	42	35
o/w Oil	868	748	40	-6	1	21	97	254	322	387	363	373
Non-Oil	-736	-891	-995	-422	-394	-417	-386	-327	-332	-303	-321	-338
MEMORANDUM ITEMS												
Current Acc/GDP	0.04	-0.04	-0.30	-0.15	-0.13	-0.13	-0.09	-0.02	0.00	0.02	0.01	0.01

06-Oct-87

Non-Oil Current Acc/Non-Oil GDP	-0.40	-0.44	-0.39	-0.20	-0.18	-0.19	-0.16	-0.14	-0.13	-0.12	-0.11	-0.11
Non-Oil Exports GNFS/Non-Oil GDP	0.22	0.21	0.18	0.23	0.25	0.26	0.27	0.29	0.29	0.31	0.31	0.31
Non-Oil Imports GNFS/Non-Oil GDP	-0.56	-0.57	-0.49	-0.36	-0.35	-0.34	-0.33	-0.33	-0.33	-0.34	-0.34	-0.34
Int. Gap+IMF+PPG/ Exp. GNFS	-0.03	-0.03	-0.06	-0.03	-0.06	-0.11	-0.10	-0.08	-0.08	-0.07	-0.07	-0.06

Base-Case Scenario
Table 2: Gabon - Capital Account
(Millions US$)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
CAPITAL ACCOUNT BALANCE	-91	92	826	307	356	413	303	79	20	-3	-19	-12
LONG-TERM CAPITAL (net)	201	254	453	551	579	479	270	79	20	-3	-19	-12
o/w Pub & Guar Debt(net)	48	85	312	245	183	-48	-58	-9	-89	-124	-138	-98
Disbursements	234	255	456	292	200	189	155	171	182	218	238	248
Amortization	-185	-171	-145	-47	-17	-237	-213	-180	-271	-342	-376	-346
Gap(net)	0	0	0	0	4	191	160	23	23	12	10	-23
Disbursements	0	0	0	0	4	191	160	23	23	12	38	28
Amortization	0	0	0	0	0	0	0	0	0	-1	-28	-51
Private (net)	153	169	141	307	392	336	168	65	85	109	109	109
Oil Sector (net)	153	169	136	300	375	312	141	42	61	86	86	83
DFI	89	105	55	141	171	190	124	72	75	74	78	82
Disbursements	179	173	193	307	370	299	207	143	150	147	156	164
Amortization	-114	-109	-113	-148	-166	-177	-190	-173	-164	-134	-148	-163
Non-Oil Sector(net)	0	0	6	6	17	23	27	23	24	23	23	26
DFI	0	0	3	3	7	13	17	15	15	14	14	17
Disbursements	0	0	3	3	10	10	10	8	10	12	14	16
Amortization	0	0	0	0	0	0	0	-1	-1	-3	-5	-7
OTHER CAPITAL (net)	-292	-162	372	-245	-223	-67	33	0	0	0	0	0
o/w Short-term Capital(net)	-188	-49	396	-245	-223	-67	33	0	0	0	0	0
Other Capital & E+O(net)	-104	-113	-23	0	0	0	0	0	0	0	0	0
OVERALL BALANCE	41	-51	-130	-121	-38	17	14	6	9	80	23	23
FINANCING	-41	51	130	121	38	-17	-14	-6	-9	-80	-23	-23
BEAC	-41	51	130	121	38	-17	-14	-6	-9	-80	-23	-23
o/w IMF (net)	-2	0	32	26	67	0	-17	-28	-31	-37	0	0
Other (net)	-39	51	98	95	-28	-17	3	22	22	-43	-23	-23
MEMORANDUM ITEMS												
Debt Service (incl. IMF)/EXGNFS	0.11	0.11	0.18	0.07	0.07	0.26	0.23	0.20	0.23	0.25	0.25	0.23
Debt Service (excl. IMF)/EXGNFS	0.11	0.11	0.18	0.07	0.07	0.26	0.22	0.18	0.21	0.23	0.25	0.23

Table 3: Gabon - Current Account.
(billion CFAF)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Merchandise Exports	891	841	366	368	414	436	459	546	604	691	720	763
o/w Oil	747	694	239	244	283	294	305	365	403	452	456	471
Non-Oil	144	148	128	124	131	142	154	181	202	239	264	292
Merchandise Imports (CIF)	-388	-469	-384	-227	-221	-222	-231	-248	-268	-294	-320	-346
o/w Oil	-72	-79	-60	-60	-63	-65	-66	-70	-75	-77	-78	-80
Non-Oil	-316	-390	-324	-166	-158	-157	-165	-179	-193	-217	-241	-266
TRADE BALANCE	503	372	-18	142	193	214	228	298	337	397	400	416
o/w Oil	675	615	178	184	220	229	239	296	328	374	378	391
Non-Oil	-172	-243	-196	-42	-27	-16	-11	3	9	22	22	26
Non-Factor Services Exports	47	58	45	37	39	43	46	49	55	61	68	75
o/w Oil	18	17	10	8	9	11	12	13	15	17	19	21
Non-Oil	29	41	35	29	30	32	34	36	40	44	49	54
Non-Factor Services Imports	-376	-355	-227	-223	-253	-254	-243	-248	-265	-287	-309	-329
o/w Oil	-244	-228	-120	-155	-186	-187	-173	-174	-184	-198	-211	-220
Non-Oil	-132	-127	-106	-68	-67	-68	-70	-74	-81	-89	-99	-108
RESOURCE BALANCE	174	75	-200	-44	-21	2	31	100	126	171	159	163
o/w Oil	449	404	68	37	43	54	78	135	159	194	186	191
Non-Oil	-276	-329	-268	-81	-64	-52	-47	-35	-33	-23	-27	-28
Factor Services Receipts	21	13	10	4	3	5	6	7	7	6	8	9
o/w Oil	7	5	4	2	3	4	5	6	6	6	7	7
Non-Oil	14	8	6	2	0	1	1	1	1	0	1	2
Factor Services Payments	-108	-109	-93	-63	-81	-110	-108	-113	-117	-124	-126	-128
o/w Oil	-63	-59	-46	-30	-36	-41	-44	-48	-49	-51	-52	-53
Profits	-48	-42	-28	-10	-12	-12	-11	-14	-15	-17	-18	-19
Interest	-15	-17	-18	-20	-24	-29	-33	-34	-34	-34	-34	-35
Non-Oil	-45	-50	-47	-33	-45	-69	-64	-66	-68	-73	-73	-75
Profits	-14	-21	-16	-12	-10	-10	-10	-11	-12	-14	-16	-19
Int. Non-Guar. Private	-6	-6	-6	-7	-8	-5	-5	-5	-4	-4	-5	-5
Int. Pub & Guar Pr	-25	-23	-25	-12	-25	-51	-47	-46	-44	-44	-42	-40
Int. Gap	0	0	0	0	0	0	0	-3	-7	-10	-11	-11
Int. IMF	0	0	0	-2	-2	-2	-2	-1	0	0	0	0
GOODS & SERVICES BALANCE	87	-21	-283	-103	-99	-103	-72	-6	16	53	41	44
o/w Oil	393	350	26	9	10	16	39	93	116	149	141	145
Non-Oil	-307	-371	-309	-111	-109	-120	-111	-100	-100	-96	-99	-102
Current Transfers (net)	-29	-43	-48	-28	-20	-15	-15	-17	-20	-24	-26	-31
o/w Oil	-14	-14	-12	-11	-10	-10	-10	-11	-12	-13	-13	-14
Non-Oil	-15	-29	-36	-18	-9	-5	-5	-7	-8	-10	-13	-17
Private (net)	-26	-35	-41	-25	-17	-17	-18	-21	-23	-26	-30	-35
Public (net)	11	6	5	7	8	12	13	14	15	16	17	18
CURRENT ACCOUNT BALANCE	58	-64	-331	-131	-118	-119	-87	-24	-3	29	15	12
o/w Oil	379	336	14	-2	0	6	29	83	105	135	127	131
Non-Oil	-322	-400	-345	-129	-118	-125	-116	-106	-108	-106	-112	-118
MEMORANDUM ITEMS												
Current Acc/GDP	0.04	-0.04	-0.30	-0.15	-0.13	-0.13	-0.09	-0.02	0.00	0.02	0.01	0.01

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	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Non-Oil Current Acc/Non-Oil GDP	-0.40	-0.44	-0.39	-0.20	-0.18	-0.19	-0.16	-0.14	-0.13	-0.12	-0.11	-0.11
Non-Oil Exports GNFS/Non-Oil GDP	0.22	0.21	0.18	0.23	0.25	0.26	0.27	0.29	0.29	0.31	0.31	0.31
Non-Oil Imports GNFS/Non-Oil GDP	-0.56	-0.57	-0.49	-0.36	-0.35	-0.34	-0.33	-0.33	-0.33	-0.34	-0.34	-0.34
Int. Gap+IMF+PPG/ Exp. GNFS	-0.03	-0.03	-0.06	-0.03	-0.06	-0.11	-0.10	-0.08	-0.08	-0.07	-0.07	-0.06

Table 4: Gabon - Capital Account.
(billion CFAF)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
CAPITAL ACCOUNT BALANCE	-40	41	286	94	107	124	91	26	6	-1	-7	-4
LONG-TERM CAPITAL (net)	88	114	157	168	174	144	81	26	6	-1	-7	-4
o/w Pub & Guar Debt(net)	21	38	108	75	55	-14	-17	-3	-29	-44	-48	-34
Disbursements	102	115	158	89	60	57	46	56	59	76	83	87
Amortization	-81	-77	-50	-14	-5	-71	-64	-59	-88	-120	-131	-121
Gap(net)	0	0	0	0	1	57	48	8	8	4	4	-8
Disbursements	0	0	0	0	1	57	48	8	8	4	13	10
Amortization	0	0	0	0	0	0	0	0	0	0	-10	-18
Private (net)	67	76	49	94	118	101	50	21	28	38	38	38
Oil Sector (net)	67	76	47	92	113	94	42	14	20	30	30	29
DFI	39	47	19	43	51	57	37	23	24	26	27	29
Disbursements	78	78	67	93	111	90	62	46	49	51	55	57
Amortization	-50	-49	-39	-45	-50	-53	-57	-56	-53	-47	-52	-57
Non-Oil Sector(net)	0	0	2	2	5	7	8	7	8	8	8	9
DFI	0	0	1	1	2	4	5	5	5	5	5	6
Disbursements	0	0	1	1	3	3	3	3	3	4	5	6
Amortization	0	0	0	0	0	0	0	0	0	-1	-2	-3
OTHER CAPITAL (net)	-128	-73	129	-75	-67	-20	10	0	0	0	0	0
o/w Short-term Capital(net)	-82	-22	137	-75	-67	-20	10	0	0	0	0	0
Other Capital & E+O(net)	-46	-51	-8	0	0	0	0	0	0	0	0	0
OVERALL BALANCE	18	-23	-45	-37	-11	5	4	2	3	28	8	8
FINANCING	-18	23	45	37	11	-5	-4	-2	-3	-28	-8	-8
BEAC	-18	23	45	37	11	-5	-4	-2	-3	-28	-8	-8
o/w IMF (net)	-1	0	11	8	20	0	-5	-9	-10	-13	0	0
Other (net)	-17	23	34	29	-9	-5	1	7	7	-15	-8	-8
GAP	0	0	0	0	0	0	0	0	0	0	0	0
MEMORANDUM ITEMS												
Debt Service (incl. IMF)/EXGNFS	0.11	0.11	0.18	0.07	0.07	0.26	0.23	0.20	0.23	0.25	0.25	0.23
Debt Service (excl. IMF)/EXGNFS	0.11	0.11	0.18	0.07	0.07	0.26	0.22	0.18	0.21	0.23	0.25	0.23

Base Case Scenario
Table 5. Gabon: National Accounts
(billion 1984 CFAF)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Oil Value Added	738	776	674	642	668	686	697	717	740	725	691	672
Non-Oil Value Added	711	759	710	517	485	488	501	518	537	557	581	607
Import Duties	87	99	83	65	69	70	72	74	76	77	83	89
GDP	1536	1633	1466	1224	1222	1244	1269	1309	1353	1359	1354	1368
Imports of Goods	388	448	412	264	254	255	261	267	277	285	293	302
o/w Oil Sector	72	75	67	65	68	69	70	72	74	72	69	67
Non-Oil Sector	316	373	345	199	187	186	191	196	203	212	223	235
Imports of NFS	376	336	241	239	270	272	257	256	262	269	272	275
o/w Oil Sector	244	216	134	167	198	199	183	179	182	186	185	184
Non-Oil Sector	132	120	107	72	72	72	74	77	80	83	87	91
IMPORTS TOTAL	764	783	653	503	524	526	517	523	540	554	565	577
TOTAL RESOURCES	2300	2417	2119	1727	1746	1770	1787	1832	1893	1912	1919	1945
GFCF	479	563	420	250	259	248	216	208	214	221	228	236
o/w Oil Sector	194	223	102	140	163	153	114	103	103	103	103	103
Central Govern.	126	164	148	24	20	18	23	24	27	30	32	36
Other	159	176	171	85	77	77	78	80	84	88	93	97
Change Stocks	37	16	-8	-12	0	1	1	2	2	0	0	1
INVESTMENT TOTAL	515	579	412	237	259	249	217	209	216	221	228	237
Exports of goods	891	876	843	827	866	903	940	980	1022	1018	990	982
o/w Oil	747	731	687	665	697	723	750	776	802	782	740	715
Other	144	145	156	162	170	179	190	204	220	236	251	267
Exports NFS	47	55	45	40	42	46	48	51	54	57	60	63
o/w Oil Sector	18	16	10	9	10	12	13	13	15	16	17	18
Non-Oil Sector	29	39	35	31	32	34	36	37	39	41	43	46
TOTAL EXPORTS	938	931	888	867	908	949	989	1031	1077	1075	1050	1045
CONSUMPTION	847	907	819	623	579	573	581	592	600	616	641	663
o/w Public	284	288	275	228	189	188	189	188	187	187	188	190
Private	562	619	544	395	390	385	393	403	413	429	452	473
GDS	689	726	647	601	643	671	688	717	753	743	714	705
o/w Oil Sector	738	776	674	642	668	686	697	717	740	725	691	672

Base Case Scenario
Table 6. Gabon: National Accounts
(billion CFAF)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Oil Value Added	738	733	220	229	267	270	256	310	344	397	405	424
Non-Oil Value Added	711	808	793	584	564	584	618	664	727	796	876	965
Import Duties	87	105	93	74	80	84	88	95	103	110	125	142
GDP	1536	1646	1106	886	910	938	963	1069	1174	1302	1405	1531
Imports of Goods	388	469	384	227	221	222	231	248	268	294	320	346
o/w Oil Sector	72	79	60	60	63	65	66	70	75	77	78	80
Non-Oil Sector	316	390	324	166	158	157	165	179	193	217	241	266
Imports of NFS	376	355	227	223	253	254	243	248	265	287	309	329
o/w Oil Sector	244	228	120	155	186	187	173	174	184	198	211	220
Non-Oil Sector	132	127	106	68	67	68	70	74	81	89	99	108
IMPORTS TOTAL	764	824	611	449	474	477	474	496	533	581	629	675
TOTAL RESOURCES	2300	2470	1717	1336	1384	1415	1436	1565	1707	1883	2034	2206
GFCF	479	597	423	255	272	264	235	234	253	276	302	329
o/w Oil Sector	194	236	95	144	171	163	124	116	122	129	136	144
Central Govern.	126	174	155	25	20	19	25	27	32	37	43	50
Other	159	187	172	86	81	82	86	90	99	110	122	136
Change Stocks	37	17	-9	-12	0	1	1	2	3	0	0	1
INVESTMENT TOTAL	515	614	414	242	272	266	236	236	256	276	301	330
Exports of goods	891	841	366	368	414	436	459	546	604	691	720	763
o/w Oil	747	694	239	244	283	294	305	365	403	452	456	471
Other	144	148	128	124	131	142	154	181	202	239	264	292
Exports NFS	47	58	45	37	39	43	46	49	55	61	68	75
o/w Oil Sector	18	17	10	8	9	11	12	13	15	17	19	21
Non-Oil Sector	29	41	35	29	30	32	34	36	40	44	49	54
TOTAL EXPORTS	938	899	411	406	453	479	504	596	659	752	788	838
CONSUMPTION	847	957	892	688	659	671	695	734	792	855	944	1038
o/w Public	284	306	286	235	209	213	219	227	237	250	267	284
Private	562	651	606	453	451	457	476	507	555	605	678	754
GDS	689	689	214	199	251	267	267	336	382	447	460	493
o/w Oil Sector	738	733	220	229	267	270	256	310	344	397	405	424
Non-Oil Sector	-49	-44	-6	-30	-15	-2	11	25	38	50	56	69

Base Case Scenario
Table 7: Gabon - Financial Operations of the Central Administration
(CFAF billions)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
REVENUES & GRANTS	587.3	631.9	505.9	258.0	247.9	270.0	286.0	317.3	370.3	401.0	437.4	472.5
OIL	384.6	399.7	284.7	70.0	77.5	85.7	92.0	109.7	140.2	155.0	163.9	162.8
NON-OIL TAX	197.9	205.6	204.3	157.0	160.4	169.3	179.0	192.6	210.1	226.0	253.5	284.7
INTERNATIONAL	90.6	107.8	95.7	76.7	81.2	87.1	91.4	97.8	106.4	112.8	127.5	145.3
OTHER TAX	107.3	97.8	108.7	80.3	79.2	82.2	87.6	94.9	103.8	113.2	126.0	139.5
NON-TAX	4.8	26.6	16.9	31.0	10.0	15.0	15.0	15.0	20.0	20.0	20.0	25.0
GRANTS	4.8	5.5	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
OTHER		21.1	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
EXPD. & NET LOANS	580.5	714.8	655.8	317.0	290.7	305.3	306.4	319.4	342.4	369.5	398.9	432.4
CURRENT EXPD	241.1	261.2	262.8	211.5	210.7	235.3	232.9	239.1	249.2	261.4	273.3	286.7
WAGES & SALARIES	93.3	106.8	115.4	106.0	95.0	96.0	98.9	101.8	105.9	111.7	119.1	126.9
GOODS & SERVICES	79.5	82.9	87.2	67.9	62.0	63.0	64.9	67.5	71.2	75.1	80.0	85.3
TRANS & SUBS	30.2	30.3	27.4	21.0	16.0	18.0	18.0	18.7	19.7	20.8	22.0	23.2
INTEREST	38.1	41.2	32.8	16.6	37.7	58.3	51.1	51.1	52.3	53.7	52.3	51.4
FOREIGN	31.5	31.3	18.8	7.7	22.7	41.3	35.1	36.1	39.3	42.7	41.3	40.4
DOMESTIC	6.6	9.9	14.0	8.9	15.0	17.0	16.0	15.0	13.0	11.0	11.0	11.0
XTRABUDGET	5.5	50.0	74.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
NET LENDING		0.0	20.8	14.0	5.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
CAPITAL EXPD	333.9	403.5	298.0	91.5	75.0	70.0	73.5	80.3	93.2	108.2	125.5	145.7
BAL - COMMIT	6.8	-82.9	-149.9	-59.0	-42.8	-35.3	-20.4	-2.1	27.9	31.5	38.6	40.2
ARREARS	-50.6	10.3	58.0	-105.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
BAL - CASH	-43.8	-72.6	-91.9	-164.0	-42.8	-35.3	-20.4	-2.1	27.9	31.5	38.6	40.2
FINANCING	43.8	72.6	91.9	164.0	42.8	35.3	20.4	2.1	-27.9	-31.5	-38.6	-40.2
FOREIGN - NET	31.8	38.9	86.9	67.0	35.9	-20.3	-15.7	-1.1	-22.2	-28.4	-40.5	-37.4
BORROWING	93.7	112.0	127.0	69.0	40.1	38.7	31.5	41.6	42.0	59.1	65.2	68.9
AMORT	-61.9	-73.1	-40.1	-2.0	-4.2	-59.0	-47.2	-42.8	-64.2	-87.6	-105.7	-106.3
DOMESTIC - NET	12.0	33.7	5.0	97.0	7.0	-8.0	-10.0	-7.0	-9.0	-9.0	-9.0	-9.0
CENTRAL BANK	-7.4	-2.8	44.0	32.0	15.0	4.0	2.0	3.0	3.0	3.0	3.0	3.0
COMM BANKS	13.6	39.0	-35.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
OTHER FINANCING	5.8	-2.5	-4.0	65.0	-8.0	-12.0	-12.0	-10.0	-12.0	-12.0	-12.0	-12.0
GAP	0.0	0.0	0.0	0.0	-0.1	63.6	46.2	10.3	3.3	5.9	10.9	6.2
MEMORANDUM ITEMS												
NON-OIL TAX/GDP	24.8%	22.5%	23.1%	23.9%	24.9%	25.3%	25.3%	25.4%	25.3%	25.0%	25.4%	25.7%
OTH. N-OIL TAX/GD	13.4%	10.7%	12.3%	12.2%	12.3%	12.3%	12.4%	12.5%	12.5%	12.5%	12.6%	12.6%
PUBLIC SAVINGS	370.9	351.0	196.3	67.5	53.2	52.7	71.1	96.9	140.9	160.5	186.1	209.0
NON-OIL PUB SAV	-13.7	-48.7	-88.4	-2.5	-24.3	-33.0	-20.8	-12.8	0.7	5.5	22.2	46.2
DEBT SERV./REV.	15.9%	16.5%	11.6%	3.8%	10.8%	37.1%	28.8%	24.8%	28.0%	32.5%	33.6%	31.0%

Base Case [illegible]o
Table 8: Gabon - [illegible]d Indicators
Oil Sector

PHYSICAL MAGNITUDES		1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Crude Oil Production	(thou MT)	8731.0	8630.0	8293.0	7840.0	8200.0	8500.0	8800.0	9100.0	9400.0	9200.0	8750.0	8500.0
o/w Exports	(thou MT)	8281.0	8104.0	7612.0	7366.0	7721.3	8016.5	8311.6	8601.9	8886.9	8666.4	8195.1	7922.9
Domestic Sales	(thou MT)	450.0	526.0	681.0	474.0	478.7	483.5	488.4	498.1	513.1	533.6	554.9	577.1
Crude Oil Production	(% change)	NA	-1.2%	-3.9%	-5.5%	4.6%	3.7%	3.5%	3.4%	3.3%	-2.1%	-4.9%	-2.9%
o/w Exports	(% change)	NA	-2.1%	-6.1%	-3.2%	4.8%	3.8%	3.7%	3.5%	3.3%	-2.5%	-5.4%	-3.3%
Domestic Sales	(% change)	NA	16.9%	29.5%	-30.4%	1.0%	1.0%	1.0%	2.0%	3.0%	4.0%	4.0%	4.0%
OIL PRICES (FOB Gabon)													
Oil Price	($/bb)	28.5	26.3	12.5	15.0	16.9	16.9	16.9	18.0	19.2	20.6	21.9	23.4
Oil Price	(% change)	NA	-7.7%	-52.5%	20.0%	12.5%	0.0%	0.0%	6.8%	6.8%	6.8%	6.8%	6.8%
SOURCES AND USES OF RESOURCES (current billion CFAF)													
Value of Production		1096.5	1087.4	423.8	453.3	496.4	491.4	452.9	510.9	557.7	618.7	633.7	660.0
o/w Oil Branch		839.4	774.4	262.1	261.8	303.0	314.1	325.2	389.1	429.2	483.1	490.6	509.0
Other		257.1	313.0	161.8	191.5	193.4	177.2	127.7	121.9	128.6	135.6	143.1	151.0
Intermediate Inputs		358.5	354.2	203.6	224.7	229.9	221.7	197.0	200.5	213.4	221.9	228.9	236.3
o/w Oil Branch		140.1	136.2	111.6	108.9	115.0	119.3	124.6	132.3	142.3	147.0	149.0	152.3
Other		218.4	218.0	92.0	115.8	114.8	102.4	72.4	68.2	71.1	75.0	79.9	84.1
Value Added		738.0	733.2	220.3	228.7	266.6	269.7	255.9	310.5	344.3	396.8	404.9	423.6
o/w Oil Branch		699.3	638.2	150.5	153.0	188.0	194.8	200.6	256.8	286.8	336.1	341.6	356.7
Other		38.7	95.0	69.8	75.7	78.5	74.9	55.4	53.7	57.5	60.7	63.2	66.9
Imports		316.0	307.0	180.7	215.2	249.1	251.4	238.6	243.3	258.5	275.0	289.1	300.7
o/w Goods (cif)		72.0	79.0	60.4	60.2	63.3	64.8	65.9	69.5	74.7	77.2	78.5	80.3
Rentals		244.0	228.0	120.3	155.0	185.9	186.6	172.6	173.7	183.8	197.8	210.6	220.4
Exports		765.3	711.0	248.6	252.2	292.2	305.1	316.9	378.0	417.8	468.7	475.1	491.9
o/w Crude		747.3	694.0	238.8	244.2	283.2	294.1	304.9	365.0	402.8	451.7	456.1	470.9
Other		18.0	17.0	9.8	8.0	9.0	11.0	12.0	13.0	15.0	17.0	19.0	21.0
Investment		194.0	235.8	95.5	143.8	170.8	163.1	124.3	116.2	122.0	128.7	136.4	143.7
o/w DFI		38.8	47.2	19.1	43.2	51.2	57.1	37.3	23.2	24.4	25.7	27.3	28.7
Foreign Loans		76.2	77.8	66.8	93.5	111.0	89.7	62.2	46.5	48.8	51.5	54.5	57.5
Local Cash Flow		77.6	110.8	9.5	7.2	8.5	16.3	24.9	46.5	48.8	51.5	54.5	57.5
SOURCES AND USES OF RESOURCES (constant 1984 billion CFAF)													
Value Added		738.0	776.2	673.7	641.7	668.2	686.0	696.7	717.2	740.0	724.8	690.6	671.6
o/w Oil Branch		699.3	687.4	630.1	595.6	623.0	645.8	668.6	691.4	714.2	699.0	664.8	645.8
Other		38.7	88.9	43.6	46.1	45.2	40.2	28.1	25.8	25.8	25.8	25.8	25.8
Imports		316.0	290.4	201.1	232.0	265.9	268.3	252.3	250.8	255.9	258.0	254.3	251.5
o/w Goods (cif)		72.0	74.8	67.2	64.9	67.5	69.1	69.7	71.7	73.9	72.4	69.1	67.2
Rentals		244.0	215.7	133.9	167.1	198.4	199.2	182.6	179.1	181.9	185.5	185.3	184.3
Exports		765.3	747.4	696.7	673.3	706.4	735.2	762.8	789.7	816.8	798.0	756.3	732.5
o/w Crude		747.3	731.3	686.9	664.7	696.8	723.4	750.1	776.3	802.0	782.1	739.5	715.0
Other		18.0	16.1	9.8	8.5	9.6	11.7	12.7	13.4	14.8	15.9	16.7	17.6
Investment		194.0	222.9	101.5	139.9	162.7	152.8	114.1	103.2	103.2	103.2	103.2	103.2

Base Case
Table 9: Gabon [illegible] Sector
Balance of Payments
(billions of CFAF)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
MERCHANDISE TRADE												
Exports	747.3	694.0	238.8	244.2	283.2	294.1	304.9	365.0	402.8	451.7	456.1	470.9
Imports (cif)	-72.0	-79.0	-60.4	-60.2	-63.3	-64.8	-65.9	-69.5	-74.7	-77.2	-78.5	-80.3
Trade Balance	675.3	615.0	178.4	184.0	220.0	229.3	239.0	295.5	328.0	374.5	377.6	390.6
NON-FACTOR SERVICES												
Exports	18.0	17.0	9.8	8.0	9.0	11.0	12.0	13.0	15.0	17.0	19.0	21.0
Imports (rentals)	-244.0	-228.0	-120.3	-155.0	-185.9	-186.6	-172.6	-173.7	-183.8	-197.8	-210.6	-220.4
RESOURCE BALANCE	449.3	404.0	67.8	37.0	43.1	53.7	78.3	134.8	159.2	193.7	186.0	191.2
FACTOR SERVICES (net)	-56.0	-54.0	-41.8	-28.2	-32.8	-37.2	-39.1	-41.6	-42.8	-45.1	-45.5	-46.2
Receipts	7.0	5.0	4.2	2.0	3.0	4.0	5.0	6.0	6.0	6.0	6.6	7.3
Payments	-63.0	-59.0	-46.0	-30.2	-35.8	-41.2	-44.1	-47.6	-48.8	-51.1	-52.1	-53.4
o/w Interest	-15.0	-17.0	-18.0	-20.2	-24.1	-29.4	-32.9	-34.0	-33.7	-33.8	-34.4	-34.9
Profits	-48.0	-42.0	-28.0	-10.0	-11.7	-11.8	-11.2	-13.6	-15.1	-17.4	-17.7	-18.5
PRIVATE TRANSFERS (net)	-14.0	-14.0	-12.2	-10.5	-10.2	-10.0	-10.1	-10.6	-11.9	-13.3	-13.3	-14.4
CURRENT ACCOUNT BALANCE	379.3	336.0	13.8	-1.8	0.2	6.4	29.2	82.6	104.5	135.3	127.2	130.6
CAPITAL ACCOUNT BALANCE	10.8	41.0	211.9	34.6	45.6	73.7	52.3	13.6	19.9	30.2	30.0	29.2
LONG-TERM CAPITAL (net)	66.8	76.0	46.9	91.6	112.6	93.7	42.3	13.6	19.9	30.2	30.0	29.2
o/w Direct Foreign Investment	38.8	47.2	19.1	43.2	51.2	57.1	37.3	23.2	24.4	25.7	27.3	28.7
Disbursements	78.0	77.8	66.8	93.5	111.0	89.7	62.2	46.5	48.8	51.5	54.5	57.5
Amortization	-50.0	-49.0	-39.0	-45.0	-49.7	-53.0	-57.1	-56.1	-53.3	-47.0	-51.9	-57.0
SHORT-TERM CAPITAL (net)	-56.0	-35.0	165.0	-57.0	-67.0	-20.0	10.0	0.0	0.0	0.0	0.0	0.0
o/w Suppliers Credits (net)	-41.0	-42.0	65.0	-30.0	-30.0	0.0	10.0	0.0	0.0	0.0	0.0	0.0
Other (net)	-15.0	7.0	100.0	-27.0	-37.0	-20.0	0.0	0.0	0.0	0.0	0.0	0.0
OVERALL BALANCE	390.1	377.0	225.7	32.9	45.8	80.2	81.5	96.2	124.4	165.5	157.2	159.8

Base Case Scenario
Table 10: Gabon - Key Indicators for Total Economy

	Actual				Est.		Projected								
	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
GDP Growth Rate	-4.00	4.10	2.00	5.10	6.36	-10.24	-16.49	-0.21	1.83	2.04	3.09	3.40	0.41	-0.33	1.01
GNP Growth Rate	..	..	..	..	6.45	-10.33	-16.02	-1.95	-0.59	2.58	3.29	3.75	0.29	0.22	1.40
GNP per-capita Growth Rate	..	..	..	..	4.85	-12.62	-18.17	-4.46	-3.13	-0.05	0.65	1.10	-2.28	-2.35	-1.19
Consumption per-capita Growth Rate	5.94	5.67	2.34	7.38	5.52	-12.01	-25.91	-9.43	-3.52	-1.16	-0.86	-1.21	0.07	1.35	0.90
Total DOD	989.20	896.50	788.25	1549.74	1676.73	2782.91	3129.24	3406.01	3358.41	3300.71	3291.66	3202.65	3078.18	2940.32	2842.04
DOD/XGS	0.39	0.38	0.36	0.71	0.83	2.29	2.33	2.24	2.08	1.94	1.78	1.56	1.42	1.29	1.17
DOD/GDP	0.26	0.25	0.23	0.44	0.46	0.87	1.08	1.12	1.07	1.03	1.00	0.89	0.83	0.73	0.65
Debt Service in US$	-356.96	-326.20	-276.10	-243.10	-222.50	-217.62	-86.90	-99.57	-407.61	-370.55	-329.33	-428.20	-498.79	-553.51	-543.12
Debt Service/XGS	0.14	0.14	0.12	0.11	0.11	0.18	0.06	0.07	0.25	0.22	0.18	0.21	0.23	0.24	0.22
Debt Service/GDP	0.09	0.09	0.08	0.07	0.06	0.07	0.03	0.03	0.13	0.12	0.10	0.12	0.13	0.14	0.12
Interest/XGS	0.05	0.05	0.04	0.03	0.03	0.06	0.03	0.05	0.11	0.09	0.07	0.06	0.05	0.04	0.03
Interest/GDP	0.03	0.03	0.02	0.02	0.01	0.02	0.01	0.03	0.05	0.05	0.04	0.03	0.03	0.02	0.02
Gross Investment/GDP	0.33	0.32	0.35	0.34	0.35	0.28	0.19	0.21	0.20	0.17	0.16	0.16	0.16	0.17	0.17
Domestic Savings/GDP	0.59	0.57	0.56	0.45	0.40	0.13	0.17	0.21	0.22	0.21	0.25	0.26	0.29	0.28	0.28
National Savings/GDP	0.49	0.47	0.45	0.37	0.32	0.04	0.09	0.12	0.11	0.11	0.15	0.17	0.20	0.20	0.20
Marginal National Savings Rate	..	..	..	0.00	-2.63	0.85	-0.26	-2.79	0.49	0.23	0.84	0.77	0.65	-0.31	0.21
Public Investment/GDP	0.13	0.14	0.17	0.08	0.10	0.10	0.02	0.02	0.01	0.02	0.02	0.02	0.02	0.02	0.03
Public Savings/GDP	..	..	..	0.24	0.20	0.12	0.05	0.04	0.05	0.05	0.06	0.08	0.09	0.09	0.10
Private Investment/GDP	0.20	0.19	0.18	0.25	0.25	0.18	0.17	0.20	0.19	0.15	0.14	0.14	0.14	0.14	0.15
Private Savings/GDP	..	..	..	0.13	0.12	-0.08	0.04	0.08	0.07	0.06	0.09	0.09	0.11	0.10	0.10
Ratio of Public to Private Investmen	0.66	0.74	0.97	0.32	0.39	0.56	0.11	0.08	0.08	0.12	0.13	0.14	0.15	0.17	0.18
ICOR	1.72	2.74	3.18	2.13	5.28	-3.46	-1.70	-92.00	11.57	9.81	5.54	4.71	38.53	-49.58	16.67
Government Revenues / GDP	0.39	0.41	0.38	0.38	0.38	0.46	0.29	0.27	0.29	0.30	0.30	0.32	0.31	0.31	0.31
Government Expenditures / GDP	0.30	0.30	0.36	0.38	0.43	0.59	0.36	0.32	0.33	0.32	0.30	0.29	0.28	0.28	0.28
Deficit (-) or Surplus (+) / GDP	0.09	0.10	0.01	0.00	-0.05	-0.14	-0.07	-0.05	-0.04	-0.02	0.00	0.02	0.02	0.03	0.03
Exports GNFS Growth Rate	0.13	0.12	0.10	0.12	-0.76	-4.63	-2.33	4.75	4.43	4.23	4.25	4.46	-0.12	-2.32	-0.53
Exports GNFS /GDP	0.65	0.64	0.64	0.61	0.57	0.61	0.71	0.74	0.76	0.78	0.79	0.80	0.79	0.78	0.76
Imports GNFS Growth Rate	0.23	0.17	0.24	0.14	2.51	-16.69	-22.91	4.25	0.36	-1.69	1.08	3.15	2.62	1.97	2.19
Imports GNFS /GDP	0.44	0.46	0.51	0.50	0.48	0.45	0.41	0.43	0.42	0.41	0.40	0.40	0.41	0.42	0.42
Current Account in US$	403.36	308.96	72.06	132.25	-142.94	-955.51	-427.95	-393.85	-395.20	-289.10	-73.01	-10.49	83.43	42.35	35.07
Current Account / GDP	0.10	0.09	0.02	0.04	-0.04	-0.30	-0.15	-0.13	-0.13	-0.09	-0.02	0.00	0.02	0.01	0.01
Terms of Trade Index	..	..	..	100.00	91.59	46.63	51.83	55.01	55.35	55.11	60.12	61.23	65.73	66.49	67.74

Base Case Scenario

Table 11: Gabon - Key Indicators for Non-Oil Sector

	Actual				Est.		Projected								
	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
GDP Growth Rate	4.41	5.71	2.86	2.53	7.44	-7.55	-26.49	-4.98	0.82	2.62	3.27	3.67	3.39	4.69	4.92
GNP Growth Rate	..	..	..	..	8.16	-6.98	-25.45	-8.54	-4.04	4.40	3.45	4.08	3.26	6.44	6.02
GNP per-capita Growth Rate	..	..	..	..	6.53	-9.36	-27.36	-10.88	-6.50	1.73	0.80	1.41	0.62	3.71	3.31
Consumption per-capita Growth Rate					5.52	-12.01	-25.91	-9.43	-3.52	-1.16	-0.86	-1.21	0.07	1.35	0.90
Gross Investment/GDP	..	..	..	0.40	0.42	0.39	0.17	0.17	0.17	0.18	0.18	0.18	0.19	0.19	0.19
Domestic Savings/GDP	..	..	..	-0.06	-0.06	-0.03	-0.07	-0.05	-0.03	-0.02	0.00	0.02	0.03	0.03	0.05
National Savings/GDP	..	..	..	-0.18	-0.18	-0.17	-0.18	-0.17	-0.19	-0.16	-0.15	-0.12	-0.12	-0.10	-0.08
Marginal National Savings Rate	..	..	..												
Public Investment/GDP	..	..	..	0.16	0.19	0.19	0.04	0.04	0.03	0.04	0.04	0.04	0.05	0.05	0.05
Public Savings/GDP	..	..	..	-0.02	-0.06	-0.09	0.00	-0.02	-0.02	-0.01	0.00	0.01	0.01	0.03	0.05
Private Investment/GDP	..	..	..	0.24	0.22	0.21	0.13	0.14	0.14	0.14	0.14	0.14	0.14	0.14	0.14
Private Savings/GDP	..	..	..	-0.16	-0.13	-0.07	-0.18	-0.15	-0.16	-0.15	-0.14	-0.14	-0.13	-0.13	-0.13
Ratio of Public to Private Investmen	..	..	..	0.65	0.85	0.91	0.33	0.25	0.23	0.29	0.30	0.31	0.33	0.35	0.36
ICOR	..	..	..	5.41	-5.50	-1.48	-3.36	21.12	6.56	5.49	4.89	5.44	3.97	3.82	NA
Government Revenues / GDP	..	..	..	0.25	0.25	0.25	0.29	0.26	0.28	0.27	0.27	0.28	0.27	0.27	0.28
Government Expenditures / GDP	..	..	..	0.73	0.78	0.74	0.48	0.45	0.46	0.43	0.42	0.41	0.41	0.40	0.39
Deficit (-) or Surplus (+) / GDP	..	..	..	-0.47	-0.35	-0.15	-0.02	-0.05	-0.08	-0.10	-0.14	-0.20	-0.21	-0.20	-0.18
Exports GNFS Growth Rate	..	..	..	..	6.22	4.14	1.47	4.15	5.69	5.87	6.68	7.78	6.72	6.06	6.18
Exports GNFS /GDP	..	..	..	0.22	0.21	0.24	0.33	0.36	0.38	0.39	0.41	0.42	0.44	0.44	0.45
Imports GNFS Growth Rate	..	..	..	..	9.99	-8.41	-39.95	-4.61	-0.21	2.74	2.69	4.17	4.24	4.92	4.89
Imports GNFS /GDP	..	..	..	0.56	0.58	0.57	0.47	0.47	0.46	0.46	0.46	0.46	0.47	0.47	0.47
Current Account in US$	..	..	..	-332.00	-413.00	-347.00	-132.00	-114.00	-121.00	-114.00	-108.00	-109.00	-106.00	-106.00	-103.00
Current Account / GDP	0.09	0.13	0.03	-0.42	-0.45	-0.39	-0.20	-0.18	-0.18	-0.16	-0.14	-0.13	-0.12	-0.11	-0.09
Terms of Trade Index	..	..	..	100.00	91.59	46.63	51.83	55.01	55.35	55.11	60.12	61.23	65.73	66.49	67.74

GABON

ECONOMIC AND SECTOR WORK FY88-92

TASK	AIMS AND COVERAGE	AUDIENCE	STAFF WEEKS REQUIRED		
			FY88	FY89	FY90
A. ECONOMIC WORK (ERA)					
1. CEM	ANALYSIS OF ECONOMIC PERFORMANCE AND OUTLOOK	BANK/GOVERNMENT	—	25.0	15.0
B. SECTOR WORK (SRA)					
1. AGRICULTURAL SECTOR REVIEW	DEVELOPMENT POTENTIAL IN SECTOR	BANK/GOVERNMENT	37.0	20.0	--
2. TRANSPORT SECTOR REVIEW	REVIEW OF SECTORAL POLICIES	BANK/GOVERNMENT	25.0	--	--
3. EDUCATION SECTOR REVIEW	STRATEGY TO MATCH SKILLS AND DEMAND	BANK/GOVERNMENT	3.0	--	40.0
C. CSP/DCB					
1. CSP	UPDATING OF CSP	BANK	--	12.0	5.0
D. OTHER CSW					
1. GAC	COORDINATING AID	BANK	10.0	15.0	10.0
2. EWO	MONITORING DEVELOPMENTS	BANK	7.5	5.0	5.0
3. SWO			5.0	45.0	15.0
			87.5	122.0	90.0

GABON

PROPOSED LENDING PROGRAM

(US$ million)

	FY88	FY89	FY90	FY91	FY92	FY88-92
Commitments						
SAL I	35.0					
SAL II			35.0			
AG. MARKETING/EXTENSION		15.0				
FORESTRY/ENVIRONMENT			15.0			
ROAD REHAB. & MAINT.				30.0		
PME				15.0		
TA I		5.0				
TOTAL	35.0	20.0	50.0	45.0	0.0	150.0
Disbursements (Calendar Year)	1982	1989	1990	1991	1992	
SAL I	15.0	20.0				
SAL II			15.0	20.0		
AG. MARKETING/EXTENSION		3.0	4.0	4.0	4.0	
FORESTRY/ENVIRONMENT			3.0	5.0	5.0	
ROAD REHAB. & MAINT.				5.0	7.0	
PME				2.0	6.0	
TA I		1.0	2.0	2.0	0.0	
TOTAL	15.0	24.0	24.0	38.0	22.0	123.0

Gabon: Country Risk Rating and IBRD Exposure

1. Risk Rating. Gabon's present debt-servicing difficulties 1/ are a result of an undiversified economy heavily dependent on oil, a misguided and inefficient public investment program, and an overextended and inefficient public sector. The authorities, recognizing the need for a radical realignment of their policies, are implementing a stabilization program supported by an IMF standby to address the short-run liquidity problems and are preaparing a structural adjustment program to address more longer-term issues, including diversification, public investment programming, and overextension of the public sector, and thus improve the long-term solvency of the country. Given some improvement in the price of oil, the implementation of these stabilization and adjustment programs would be sufficient for re-establishing full creditworthiness. However, country's performance should be closely monitored and the level of Bank lending should be linked to progress in the implementation of the adjustment and stabilization programs. Since Gabon's debt-servicing capacity is closely linked to the price of oil for some time to come, the effects of oil price fluctuations should also be closely monitored. Gabon's risk rating has not been re-assessed since 1978, but it is expected that the Financial Complex will do so shortly.

2. Bank Exposure. Bank exposure in Gabon's total official debt is projected to be reasonable and within the criteria established by PBD. Since in the case of Gabon debt outstanding to other preferred creditors is projected to be small, these criteria are: (a) the share of the Bank in a country's public and publicly guaranteed debt and debt service should not exceed 20 percent, and (b) debt service to the Bank should not exceed 5 percent of a borrower's exports of goods and services. Projections (Table 1) show that throughout the period 1987-95 all the criteria are met. Moreover, other less easily quantifiable factors also suggest that the Bank would not be overly exposed in Gabon. First, net disbursements by the Bank are projected to be positive throughout the initial seven-year period. Thus, it will be in Gabon's interest to service its obligations to the Bank. Second, the increase in the Bank's relative exposure is a result of the burden-sharing arrangements between Gabon's major creditors. While the Bank is injecting fresh money through fast-disbursing loans, the other creditors are providing debt relief and fresh capital.

1/ Although membership in the CFA franc zone precludes foreign-exchange constraints, the country's debt-servicing difficulties stem from the limited ability of the public sector to mobilize sufficient domestic resources.

Table 1

GABON - Selected Indicators on IBRD Exposure

	1987	1988	1989	1990	1991	1992	1993	1994	1995
Total Debt Service/Exports of GNFS	6.5	6.6	25.5	22.0	18.0	21.1	23.2	24.6	22.7
IBRD Debt Service/Exports of GNFS	0.1	0.1	0.2	0.2	0.3	0.6	0.7	0.9	1.1
IBRD Debt Service/Total Debt Service	2.1	1.9	0.7	1.1	1.9	2.8	3.1	3.8	4.7
IBRD Debt Outstanding/Total Debt Outstanding	0.2	0.5	1.1	1.7	2.9	3.7	4.6	5.1	4.9
Memorandum Items:									
IBRD Disbursements (net) (US$ Million)	-1.2	13.7	22.9	23.5	37.5	18.7	16.2	2.9	-10.9

All the data are after rescheduling eligible debt service due in 1987 and 1988.

International Bank for Reconstruction and Development

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AD HOC COMMITTEE ON BOARD PROCEDURES (BPC)

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FROM: The Secretary Board Procedures Committee

November 6, 1987

BOARD CONSIDERATION OF THE BANK'S COUNTRY LENDING STRATEGIES (CLS)

Note by Mr. Lankester

Attached is a memorandum from Mr. Lankester on "Board Consideration of the Bank's Country Lending Strategies (CLS)" which is being circulatd at his request. The precise time of the meeting mentioned in Mr. Lankester's memorandum will be confirmed later.

Distribution

Committee

Mr. Arlman
Mr. Benachenhou
Mr. Jembere
Mr. Keating
Mr. Lankester
Mr. Malan
Mr. Potter
Mr. Rao Sahib
Mr. Sherwin
Mr. Suraisry

For Information

Other Executive Directors and Alternates
President
Mr. Hopper
Mr. Qureshi
Mr. Ryrie
Mr. Shihata
Mr. Stern
Mr. Thahane
Mr. Wapenhans

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

To: Mr. Arlman
Mr. Benachenhou
Mr. Jembere
Mr. Keating
Mr. Malan
Mr. Potter
Mr. Rao Sahib
Mr. Sherwin
Mr. Suraisry

November 5, 1987

From: Tim Lankester

Tel: 623 4560

Subject: Board Procedures Committee

... I attach a note setting out my personal thoughts on why and how the Board should tackle the important issue of the Bank's country lending strategy.

I suggest that we consider this subject, amongst others, at the planned meeting of the BPC at 2.30 pm on Monday, December 7, with the Senior Vice President, Operations.

cc: Mr. Qureshi
Mr. Thahane

BOARD PROCEDURES COMMITTEE

BOARD CONSIDERATION OF THE BANK'S COUNTRY LENDING STRATEGIES (CLS)

Note by Mr. Lankester

1. This paper considers briefly the role of country programming in the Bank's operational work, and the Board's involvement (or lack of involvement) in it. It goes on to propose a pattern for future Board discussion of country lending strategies, and contains in an Annex an outline of the sort of management paper that would be a suitable basis for such discussions.

COUNTRY PROGRAMMING IN THE BANK

2. Since the McNamara reorganisation in 1972, "country focus" has been the accepted principle of the Bank's operational work defined (in the Reorganisation Steering Committee's Report) as:-

> " An orientation of plans and programs around the overall development needs of individual countries and an institutional responsiveness to those needs".

Country programming is the method by which this concept has been translated into practice and lies at the heart of the operational work of the Bank.

3. Two recent developments have been designed to strengthen the country focus of the Bank's operational work. First, the Country Assistance Management (CAM) process was developed following a review of Bank operating procedures concluded in March 1986. CAM integrates three aspects of country programming management: formulation of country strategies based on agreed priorities and objectives, coordination of the resources required for timely delivery of outputs, and the monitoring of progress and costs to react to changing circumstances. CAM is designed to make the link between country objectives and their resource costs more explicit than it had previously been, with the aim of providing a more effective and efficient service to borrowers. The introduction of CAM was paralleled by a revision in loan processing procedures to permit inter alia key policy and technical issues to be decided upon earlier in the lending cycle.

4. The second development was the recent Reorganisation of the Bank and, in particular, of the Operations Complex. Over the years the policy content of Bank lending of all types has increased substantially and the design of individual lending operations progressively raised issues of country strategy and policy that had to be integrated on a continuing basis. This was one of the central issues addressed in the Reorganisation Steering Committee's Report. The Steering Committee recommended the structural integration of Program and Policy Departments at the country level to re-establish and strengthen the country focus in the Operations Complex. The Country Director becomes the central

figure, responsible for all Bank operations in his countries and also for the work of the resident missions overseas.

Role of the Board in Country Programming

5. Despite the central role of country programming in the Bank's operations, the Board is not significantly involved in the process. It essentially deals with the work of the Operational side of the Bank by approving individual lending operations. However, these discussions do not provide a satisfactory opportunity to consider lending strategy. While some material about the Bank's programme in the country is included, there is no overview of the future lending plans. It would clearly be an inefficient use of the Board's time to rediscuss strategic questions each time a project was submitted. Such issues are sometimes raised by individual Directors, but the Board never addresses them systematically.

6. Recently Executive Directors have approached the treatment of country issues through discussion of the Policy Framework Papers in the Committee of the Whole. These discussions have demonstrated the Board's interest and capacity to discuss country strategies over the medium term. But they are focused on a country's development prospects and policies rather than on the Bank's contribution which is dealt with only partially and in passing, and being joint documents of the Bank, the Fund, and the Government, they do not provide a wholly suitable vehicle for discussing the Bank's country lending strategies.

7. It is abnormal for the Board of a major lending institution to lack substantive and systematic involvement in its lending strategy. Indeed this anomaly has been recognised on a number of occasions in the past and specifically highlighted in the proposals put to the Board following the Review of Bank Operating Procedures (R86-34) as follows:-

> " Management believes that it is essential for the Board to have an opportunity to discuss the Bank's assistance strategy for each borrower to provide the overall context for individual lending operations".

A response to this call from management is long overdue.

8. It is interesting to note that the country lending strategy concept is to some extent present in recent papers circulated for the Joint Audit Committee by OED on the reviews of Bank/Country relationships. In the papers it is proposed to review the Bank's lending program from the viewpoints of size, content, assessment of the integrity of each operation and the quality of the overall program on the basis of certain criteria. It is somewhat ironic that the Joint Audit Committee should have determined to review these matters retrospectively before the Board itself has decided to take a role in the forward planning and evolution of the Bank's country lending strategy.

A PATTERN FOR BOARD DISCUSSION OF COUNTRY LENDING STRATEGIES

9. Board discussion might best be timed to coincide with the presentation to the Board of one (or more) of the following:

a. A Policy Framework Paper; or
b. A policy based operation; or
c. One or more specific major projects; or
d. Documentation for a consortium or consultative group meeting.

Such an approach would to some extent reduce the extra time taken by the Board. Further time could be created for Country Lending Strategy discussion by extending the limits of the existing Special and New Presentation Procedures (on which a separate proposal could be considered) so that less of the project business of a more routine kind came to the Board for consideration.

10. Board discussions of Country Lending Strategies would need to be fitted into a forward Board programme of policy and operational discussions, the need for which has already been identified in this Committee's deliberations. Management could be requested to draw up a timetable, perhaps covering the most significant borrowers once a year and smaller borrowers every two years.

11. The discussion would be on the basis of a management paper which would direct the Board's attention to key issues. The paper would need to include sections on background and the Bank's existing program and sectoral priorities (these sections would be much the same as the existing Country Briefs) plus a section presenting outline plans for the Bank's lending program over the next three year period. A final section would pick up the main points for consideration by the Directors. An outline of such a paper is contained in the Annex.

12. A final question is what form of decision or other action the Board would take after its discussion. There is a range of possibilities:-

(i) formal agreement on size, content, and sectoral strategy priorities for the forward three years' lending programme.

(ii) broader but less formal agreement on size (with relatively firm figures for year one, and broader indications for the two forward years) and sectoral lending strategy, with delegation to management to react to changing circumstances, but with major variations reported to the Board.

(iii) no formal agreement recorded but a chairman's summing up identifying the thrust of Directors' comments for management to take into account.

The first option would meet the requirement for full Board involvement in these important decisions, but would arguably permit insufficient flexibility for management, and would not sit easily with the desire to achieve greater delegation down the line in the Operations Complex. The last option would create the opportunity for the Board to discuss country lending strategies, but otherwise take us little further forward than the present situation. The debates would tend to lack focus, and there would be no benchmarks by which to compare progress in successive annual discussions. The second option identified above presents the opportunity for the Board to provide a reasonable degree of guidance to management, whilst allowing them flexibility to react to changing internal and external circumstances without the continual need to submit to the Board for approval of variations in the agreed strategy. A summary by the Chairman at the conclusion of each discussion would be the means of recording the Board's decisions and act as the starting point from which to measure progress in the next annual (or two-yearly) meeting.

13. Various permutations of these basic options could of course be considered.

Office of UK Executive Director

5 November, 1987

ANNEX

BOARD PROCEDURES COMMITTEE

Suggested Outline of Bank Country Strategy Papers for Board Consideration

1. Directors already have available the Bank's Country Briefs (updated every six months) on all active borrowers. These papers are designed for general background information purposes. Regional management in the Operations Departments of course have their CAM business plan for the three forward years together with Country Strategy Papers (introduced in 1986).

2. More targetted and policy oriented papers, distilling elements of all the above, could be devised as the basis for discussion by the Board of the Bank's proposed lending strategy to a particular country. These could comprise sections as follows:-

- Background: More focussed on the preceding 2-3 years. Economic/political/social.

- Current Economic Situation: Brief overview expanding on sectoral issues and priorities to be addressed. Details of Bank's existing program and sector mix, together with highlighting any problems encountered.

- Forward Look: Priorities and objectives for Bank attention over the forward three years; means by which these objectives to be achieved; inclusion of any available matrix of Governmental actions if policy framework paper/SAL/SECAL are involved; proposed size and content of future lending program including outline of specific operations envisaged. Commentary on any regional considerations.

- Donor Coordination: More, or less, active role for the Bank?

- Special Concerns: Environmental, poverty orientation, role of women.

- Strategic Issues for Focussing Board Discussions.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 13, 1987

TO: Members, Policy Committee

FROM: W. A. Wapenhans

EXTENSION: 75656

SUBJECT: Review of the Tax Allowance System

1. Attached for your review is a paper to the Executive Directors (Attachment 1) on the review of the current Tax Allowance System. This paper fulfills the commitment made to the Board when the current system based on average deductions was introduced in 1980.

2. The paper:

   (a) assesses the operation of the average deduction since its introduction;

   (b) recommends some modifications to the system in response to recent changes in US tax laws; and

   (c) proposes an agenda for further study.

3. A copy of the full report of the joint Bank/IMF Working Group is at Attachment 2. This is considered too detailed for distribution to the Board, although copies will be made available to any interested directors. A copy of the Staff Association's comments are at Attachment 3. They had no objections to the proposals, although predictably they would have liked to have seen a more wide ranging study of the entire tax system.

4. A paper with identical proposals has been submitted to the IMF board on an absence of objection basis. No objections have been received, and it is expected that the proposals will be approved by close of business today.

5. In view of the above and because the modifications proposed are relatively minor and non-controversial, unless members of the committee feel otherwise, no discussion of the paper by the committee is proposed.

Attachments

Report of the Joint Working Group on the Average Deduction System

I. Introduction

After an extensive review in the context of the Joint Committee on Staff Compensation Issues (the Kafka Committee), the Executive Boards of the Bank and the Fund approved the introduction, beginning in 1980, of a new tax allowance system based on the average deductions claimed by U.S. taxpayers generally. The new system replaced a system based on standard deductions that had been in effect since the early days of the two institutions.

At the time the average deduction system was introduced, it was decided that a comprehensive review of that system would be undertaken at the end of a five-year transitional period. That review was due in 1985, but it was postponed in view of the major revisions of the U.S. tax code, which were then being considered, and which led to the adoption on October 22, 1986 of the far-reaching Tax Reform Act of 1986. The present paper has the twofold objective of (i) undertaking the review of the implementation of the average deduction system that was to have taken place at the end of the five-year transition period, and (ii) considering the implications of the Tax Reform Act on the average deduction system.

This paper is limited to the review of the operation of the tax allowance system and the adjustments to the existing system needed to take account of the 1986 Tax Reform Act. Other issues, such as equity considerations arising outside the tax allowance system, including the appropriateness of the dependency allowance, treatment of spouse income, and the implications of the 1984 Tax Act for G-IV visa holders are not included. These subjects raise more fundamental issues of the impact of the tax allowance system in relation to the equitable treatment of all staff with respect to the income they earn from the Bank and Fund. Furthermore, this paper does not examine the difficult and more fundamental issue of the longer-term feasibility of the average deduction system in the light of the far-reaching implications of the 1986 Tax Reform Act for average deductions generally after the law is fully implemented. Accordingly, these issues of equity and the future feasibility of the average deduction system will be taken up by the Bank and Fund staff as the full implications of the Act become clearer.

II. Considerations in Establishing the Average Deduction System

1. The previous tax reimbursement system based on standard deductions was considered to be broadly reasonable when it was established in 1946. Over time, however, standard deductions did not keep pace with nominal incomes

and with changes in the tax code. 1/ By the mid-1970s, there was broad agreement among the staff associations, administrations, and managements of the Bank and Fund that the system needed to be changed. There was, however, a wide divergence of views as to what the primary objective of a tax allowance system should be, and the type of system that should be adopted. The average deduction system, as adopted in 1980, is a compromise between competing objectives, and an understanding of the objectives that were weighed at the time the system was adopted is useful in understanding its various features.

2. The two main objectives were

a. Internal equity between U.S. nationals and expatriate staff

The criterion of equal pay for equal work must be applied at the net salary level; thus, all other things being equal, staff members at the same grade should earn the same net income. U.S. staff have tax liabilities that vary depending on their personal circumstances; internal equity requires a tax allowance system which fairly recognizes these liabilities and neither underreimburses nor overreimburses taxes paid, which would have an impact on after-tax income.

b. External equity between Bank/Fund employees and those employed outside (i.e., symmetry with the compensation-setting process)

Bank/Fund net salaries are derived from external gross salaries by application of the appropriate tax rates and deductions to outside gross salaries. Thus, symmetry requires that this netting-down process be as close as possible to the grossing-up process used to develop tax allowances. Otherwise, the gross equivalents of U.S. nationals in the two organizations will deviate substantially from the gross salaries of external comparators.

3. The Kafka Committee considered a range of alternative tax allowance systems in the light of these two objectives, as well as other criteria,

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1/ Under the Internal Revenue Code, taxpayers may either itemize their personal deductions or take the standard deduction (called the "zero bracket amount" from 1978 to 1986), whichever is more advantageous. Personal deductions are those that can be itemized on Schedule A of the U.S. Individual Income Tax Return such as medical/dental expenses, state and local taxes, interest expense, charitable contributions, etc. The Tax Reform Act of 1986 altered substantially the types and amounts of deductions that can be claimed by those who itemize. The standard deduction that can be claimed by those who do not itemize depends upon the filing status, i.e., married filing jointly, head of household, single, or married filing separately. The relationships between the standard deductions for these various categories have changed substantially over time, and certain problems in the implementation of the average deduction system for low-income staff that have arisen as a result of these changes are addressed later in this paper.

especially cost but also ease of administration and comprehensibility to staff. The system adopted in 1980 was intended to strike a balance between these various objectives. On the one hand, it takes into account in the calculation of tax allowances each staff member's actual circumstances with respect to state of residence, number of personal exemptions, 1/ and, with one important exception discussed below, filing status (e.g., single and head of household). On the other hand, in order to provide substantial symmetry with the compensation process, the average deduction system assumes that each U.S. staff member claims the same level of personal deductions, other than federal deductions for state income taxes, that is claimed on average by U.S. taxpayers nationwide in the same adjusted gross income bracket. The deductions used in grossing up are, therefore, the same as those used in netting down for compensation purposes. As part of the review that led to the adoption of the average deduction system, a survey of U.S. nationals' actual tax returns for 1976 was undertaken in 1977 and compared with the most recent Internal Revenue Service (IRS) national data then available, which were for 1973. It was found that on average the personal deductions (including state and local income taxes) claimed by U.S. staff members followed the national averages fairly closely, although the dispersion in deductions claimed by individual U.S. staff at each income level was quite wide.

4. Nonorganization income

a. Spouse income

A further way in which the average deduction system diverges from strict symmetry is in the treatment of spouse income. The somewhat complex system employed with respect to spouse income can best be understood in terms of its historical evolution. When the Bank and the Fund first introduced a tax allowance system in 1946, there was only one tax rate schedule in the U.S. tax code, and each individual, married or single, was taxed on his own income. This aspect of the U.S. tax code was, however, called into question by a court determination that married couples residing in states that had community property laws could divide family income equally between them in filing federal as well as state income taxes. With progressive tax rates, this "income splitting" could result in significant tax savings. In order to provide more equitable treatment between residents of states with different legal provisions, the United States Revenue Act of 1948 introduced the married-filing-jointly tax rates, extending to all married couples the possibility of income

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1/ Every taxpayer is entitled to one personal exemption, e.g., married couples filing jointly are entitled to two exemptions. In addition, both married and single taxpayers can claim a personal exemption for each dependent child or other qualifying dependent residing in the taxpayer's household. The personal exemption is subtracted from gross income in determining taxable income.

splitting and the corresponding tax savings. 1/ In deciding to take advantage of the reduced rates for married taxpayers who file jointly, the Bank and Fund concluded that they, also, needed to take into account the impact of the spouse's income, both earned and investment, because the actual rate at which income from the organizations was taxed reflected their combined income. The provisions introduced by the organizations for taking account of spouse income were thus deemed to be consistent with the provision of the By-Laws, that, in calculating the amount in respect of taxes, the staff member's income from the Bank and Fund should be presumed to be his total income. The net result of these changes was a significant savings to the Bank and Fund. Therefore, in cases where the spouse had no income or less income than the staff member, the organizations (1) used the new income-splitting provision in calculating the joint tax liability, (2) calculated the spouse's tax liability by assuming the spouse filed at the higher separate rates, and (3) paid the staff member the difference as a tax allowance. Where spouse income was greater than the staff member's, the organizations ignored the new income-splitting provisions and calculated the staff member's tax allowance based on organization income and on the assumption that he filed separately. This method of taking into account the income-splitting provisions available under the U.S. tax code was retained as a feature of the average deduction system on the recommendation of the Kafka Committee. The only change introduced with the average deduction system in 1980 was that average, instead of standard, deductions would be used in each of the required calculations with respect to staff or spouse income.

b. Staff member's nonorganization income

The report of the Kafka Committee recognized that one of the most difficult problems posed in analyzing alternative tax allowance systems was the allocation of tax liability between organization income and nonorganization income, both spouse and investment income. After weighing the various alternatives, the Committee recommended that spouse income

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1/ The U.S. individual income tax has four rate schedules. Listed in order from the lowest to the highest tax rates, these are: married filing jointly, head of household, single, and married filing separately. The head-of-household rates are available to single parents with dependent children. The married-filing-separately tax rates are designed so that any given marginal tax bracket is reached at half the taxable income level as under the married-filing-jointly schedule, e.g., in 1986 the 50 percent marginal tax bracket applied to taxable income above $175,250 for married couples filing jointly and to taxable income above $87,625 for married individuals filing separately. Given progressive tax rates, it is generally advantageous for married couples--unless they are at the same income level--to file jointly. The high married-filing-separately rates are, therefore, rarely used in practice; they do, however, play an important role in the tax allowance systems of the Bank and Fund.

continue to be treated as described above but that no account be taken of the staff member's non-Bank/Fund income. The Kafka Committee's report acknowledged that, given the tax provisions in place at that time, the system would result in less favorable treatment of U.S. staff members than non-U.S. staff with respect to non-Bank/Fund income. 1/ With respect to spouse income, this difference resulted primarily from the fact that, in most cases, the tax allowance system attributed tax to the spouse of the U.S. staff member on the basis of the high married-filing-separately rates, while working spouses of most non-U.S. staff could at that time file using the married joint rates. 2/ With respect to investment income, the difference resulted from the fact that for U.S. staff members all such income was taxed at the marginal rates on top of their gross organization income.

5. The new system was made fully effective for U.S. nationals joining the Bank or Fund after December 31, 1979. For those U.S. nationals already employed on that date two special features were adopted. First, because the new system was expected to result in tax allowances which would be significantly less than under the old system, a five-year transitional period was provided to avoid a sudden sharp reduction in income from the organization. Thus, in 1980 eligible staff received as tax allowance, in addition to the amount calculated under the new system, a supplemental transitional payment which was five sixths of the difference between the amounts calculated under the old and new systems. This additional payment was reduced each subsequent year by one sixth of the difference between the two amounts, the last transitional payment being

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1/ International Bank for Reconstruction and Development/International Monetary Fund, Report of Joint Committee on Staff Compensation Issues, CSCI/79/1 (January 1979); (pp. 37-38) 6.38.2: "Two important advantages of an average deduction scheme would be that Bank and Fund equivalent gross salaries could be seen to have a direct connection with those payable in the United States market and that net salaries could continue to be set at the same level for all staff. From the point of view of internal equity, however, the latter argument should not be taken too far, since the aftertax net salaries of non-expatriates would vary according to their individual circumstances and expatriates would still receive more favored treatment in respect of outside income. The system would not alter the fact that, compared with United States nationals, expatriates would have the advantage of paying lower rates of tax on outside income. Any feeling of divisiveness which might be caused between expatriates and local nationals on this score, however, could be alleviated, to some extent at least, if local nationals were allowed to take spouse income into account for reimbursement purposes in the same way as at present."

2/ Since 1985 most staff members holding G-IV visas have been taxed by the United States as nonresident aliens. Where such staff member has a working spouse who also has a G-IV visa, the spouse is now obligated to file a separate tax return and is taxed at a higher rate.

made in 1984. Second, U.S. nationals serving the organizations before the introduction of the new system were made eligible (without time limit) for safeguard (or safety net) payments. These payments are aimed at ensuring that the staff member receives a total tax allowance that is at least equal to the taxes imputed to his organization income based on actual deductions from the actual tax returns he files. This feature was introduced to ensure that the provisions of the applicable By-Laws of the two organizations were met for staff members hired while those By-Laws were in effect. (The relevant By-Laws were amended with the introduction of the new system.)

III. Results of the Average Deduction System During the Period 1980-85

1. Relevant data on tax allowance payments and changes in gross pay for the period 1980-85 are set forth in Tables 1 through 5. Data are shown separately for the Bank (B) and Fund (F) in Tables 1-3. It will be seen that the only significant differences between the two organizations during the period covered were those resulting from the numbers of U.S. nationals employed by each organization.

2. Cost of tax allowances

a. From 1979 to 1985 the number of U.S. nationals employed by the Bank and the Fund increased slightly from 2,074 to 2,141. In the same period, total tax allowance payments to U.S. nationals rose by 18 percent, from US$33.2 million to US$39.1 million (Table 1). However, this increase was much smaller than the increase in the total salary bill for U.S. staff. The Fund's computerized database on tax allowances, but not that of the Bank, permits an analysis of such allowances relative to net income levels. Between 1979 and 1985, total stated net salaries of U.S. nationals employed by the Fund rose by 74.5 percent. Over this same period, total income tax allowances paid to U.S. nationals in the Fund rose by only 20.5 percent. As a result, tax allowances as a percent of staff net compensation declined from 71 percent in 1980 to 49 percent in 1985. Although this reduction in tax allowances as a percent of staff net compensation reflects primarily the change in the tax allowance system, it also reflects reductions in federal tax rates (Tables 4 and 5).

b. All U.S. staff hired before 1980 were eligible for transitional payments during the five years 1980 through 1984. Transitional payments during this period amounted to US$24.7 million for the Bank and US$7.4 million for the Fund (Table 2). Pre-1980 staff whose actual deductions are less than the average deductions assumed are also eligible to apply for supplementary payment under the safeguard provisions. During the five-year transition, such safeguard payments were made only to the extent that the amount the staff member was entitled to under the safeguard calculations exceeded the amount he had received from the Bank or Fund, including the tax allowance payment and transition payment. The percentage of pre-1980

Table 1. Tax Allowance Payments for U.S. Staff, 1980-85

		1980	1981	1982	1983	1984	1985
Total Tax Allowances							
Number of staff	B	1,643	1,672	1,718	1,610	1,633	1,654
	F	431	481	464	466	478	487
		(Millions of U.S. dollars)					
Tax allowance payments 1/	B	25.4	36.6	32.4	28.7	28.9	29.7
	F	7.8	11.3	9.5	8.8	9.1	9.4
Average payment	B	0.016	0.022	0.019	0.018	0.018	0.018
	F	0.018	0.024	0.021	0.019	0.019	0.019
Pre-1980 staff							
Number of staff/percent of total	B	1,545/94	1,400/84	1,326/77	1,102/68	1,059/65	975/60
	F	403/94	393/82	349/75	328/70	312/65	305/63
		(Millions of U.S. dollars)					
Tax allowance payments	B	24.9	34.2	28.5	23.7	22.7	21.1
	F	7.7	10.7	8.5	7.4	7.2	7.0
Average payment	B	0.016	0.024	0.021	0.021	0.021	0.022
	F	0.019	0.027	0.024	0.023	0.023	0.023
Post-1979 staff							
Number of staff/percent of total	B	98/6	272/16	392/23	508/32	574/35	679/41
	F	28/6	88/18	115/25	138/30	166/35	187/37
		(Millions of U.S. dollars)					
Tax allowance payments	B	0.488	2.393	3.878	5.067	6.266	8.604
	F	0.078	0.635	1.011	1.365	1.841	2.445
Average payment	B	0.005	0.009	0.010	0.010	0.011	0.013
	F	0.003	0.007	0.009	0.010	0.011	0.013

Summary

(Data for Bank and Fund combined; millions U.S. dollars)

	1980	1981	1982	1983	1984	1985	Totals 1980-85
Pre-1980 staff	32.6	44.9	37.0	31.1	29.9	28.1	203.6
Post-1979 staff	0.6	3.0	4.9	6.4	8.1	11.0	34.0
All staff	33.2	47.9	41.9	37.5	38.0	39.1	237.6

1/ The substantial increase in tax allowance payments from 1980 to 1981 is largely attributable to the fact that in 1981 sizable general salary increases were approved by the two organizations, retroactive to March 1980. The resulting payments were made to the staffs in 1981 and for U.S. income tax purposes were in their entirety for 1981 income, thus incurring taxes at the highest marginal rates applicable for the year.

Table 2. Composition of Tax Allowance Payments to Pre-1980 Staff, 1980-85

		1980	1981	1982	1983	1984	1985
Average deductions							
Number of staff	B	1,545	1,400	1,326	1,102	1,059	975
	F	403	393	349	328	312	305
		(Millions of U.S. dollars)					
Total payments	B	18.1	26.8	22.8	20.2	20.5	21.1
	F	5.7	8.3	7.0	6.3	6.6	7.0
Average payment	B	0.011	0.019	0.017	0.018	0.019	0.022
	F	0.014	0.021	0.020	0.019	0.021	0.023
Supplemental transitional payments							
Number of staff	B	1,545	1,400	1,326	1,102	1,059	0
	F	403	393	349	328	312	0
		(Millions of U.S. dollars)					
Total payments	B	6.7	7.4	5.6	3.3	1.7	0
	F	2.1	2.3	1.5	1.0	0.5	0
Average payment	B	0.004	0.005	0.004	0.002	0.002	0
	F	0.005	0.006	0.004	0.003	0.002	0
Safeguard (safety net) payments							
No. of staff qualifying/ percent of pre-1980 staff	B	78/5	114/8	125/9	134/12	206/19	244/25
	F	21/5	37/9	36/10	54/16	72/23	87/29
		(Millions of U.S. dollars)					
Total payments	B	0.014	0.059	0.104	0.195	0.440	0.781
	F	0.006	0.027	0.044	0.094	0.180	0.331
Average payment	B	0.0002	0.0005	0.0008	0.0015	0.0021	0.0021
	F	0.0003	0.0007	0.0012	0.0017	0.0025	0.0038

Summary

(Data for Bank and IMF combined; millions of U.S. dollars)

	1980	1981	1982	1983	1984	1985	Totals 1980-85
Average deduction system	23.8	35.1	29.8	26.5	27.1	28.1	170.4
Supplemental transitional payments	8.8	9.7	7.1	4.3	2.2	0	32.1
Safeguard (safety net) payments	0	0.1	0.1	0.3	0.6	1.1	2.2
Total payments to pre-1980 staff	32.6	44.9	37.0	31.1	29.9	29.2	204.7

Table 3. Total Payments to Pre-1980 Staff Under Average Deductions Method Compared with Standard Deductions Method

(1980-84)

Year		Actual Average Deductions Method (1)	Hypothetical Standard Deductions Method (2)	Column (1) as Percent of Column (2) (3)
		(Millions of U.S. dollars)		(Percent)
1980	B	18.1	26.2	69
	F	5.7	8.4	68
1981	B	26.8	37.9	71
	F	8.3	12.1	69
1982	B	22.8	32.6	70
	F	7.0	10.3	68
1983	B	20.2	29.9	68
	F	6.3	9.7	68
1984	B	20.5	30.7	67
	F	6.6	9.5	69
		142.3	206.9	69

Table 4. Tax Allowance Payments in the Fund as Percentage of Net Salaries

(1980-85)

Year	Total Tax Allowance Payments (1)	Total Net Salaries (2)	Column (1) as Percent of Column (2) (3)
	(Millions of U.S. dollars)		(Percent)
All staff			
1980	7.8	11.0	71
1981	11.3	15.3	74
1982	9.5	15.9	60
1983	8.8	17.7	50
1984	9.1	18.3	50
1985	9.4	19.2	49
Pre-1980 staff			
1980	7.7	10.8	71
1981	10.7	14.1	76
1982	8.5	13.5	63
1983	7.4	14.0	53
1984	7.2	13.9	52
1985	7.0	13.4	52
Post-1979 staff			
1980	0.078	0.225	35
1981	0.635	1.250	51
1982	1.011	2.394	42
1983	1.365	3.469	39
1984	1.841	4.663	39
1985	2.445	5.837	42

Table 5. Tax Allowance Payments to all U.S. Staff in the Fund as a Percentage of Their Total Gross Income

(1980-85)

Year	Total Tax Allowance Payments (1)	Total Gross Income 1/ (2)	Column (1) as Percent of Column (2) (3)
	(Millions of U.S. dollars)		(Percent)
1980	7.8	19.4	40
1981	11.3	27.7	41
1982	9.5	26.5	36
1983	8.8	27.9	32
1984	9.1	29.0	31
1985	9.4	28.6	33

1/ Including, inter alia, tax allowance payments and Social Security tax reimbursements.

staff receiving safeguard payments increased steadily from 5 percent in 1980 to 25 percent in 1985 for the Bank and from 5 percent to 29 percent for the Fund. If the actual deductions of Bank and Fund staff followed closely the national averages, about 50 percent of pre-1980 staff might be expected to qualify for safeguard payments. However, it is possible that staff may not bother to apply when the difference between actual and assumed deductions is small. Staff may also decide not to apply because they or their spouses are concerned about the confidentiality of their income tax returns or because they do not understand the safeguard provisions. Total safeguard payments by the Bank and the Fund during the five-year transition amounted to US$812,000 and US$350,000, respectively. A further US$1.1 million was paid by the two organizations in 1986 with respect to the 1985 tax allowances.

c. Before the average deduction system was introduced, the Bank/Fund tax consultants, Arthur Andersen & Company, had estimated that,

apart from any transition and safeguard payments, tax allowance payments under the system would on average be about 70 percent of what they would have been had the previous system based on standard deductions remained in effect. During the transition period, tax allowances for pre-1980 staff were calculated under both systems. As can be seen from Table 3, for the years 1980-84 the tax allowance payments calculated under the average deductions method were about 69 percent of those calculated under the previous system.

IV. Review of Operation Up to 1986

The average deduction system was adopted by the Bank and Fund following the Recommendations of the Joint Committee on Staff Compensation Issues--Tax Reimbursement (January 1979, p.39). The report concluded:

"6.42 We recommend, therefore, that:

(i) the Bank and Fund should adopt an Average Deduction System of tax reimbursement - based on the average deductions claimed by United States nationals generally, with modifications to reflect conditions in the Washington area with allowances being made for spouse income in the same way as happens under the present system;

(ii) the Bank and Fund, in implementing an Average Deduction System, should search for all means of ensuring more equitable treatment amongst all staff;

(iii) the Bank and Fund should again discuss with the Governments concerned the possibility of their taking the necessary steps to eliminate the burden that results from the taxation by those Governments of their nationals employed in their own countries by the Bank and Fund."

During the past six years several issues have arisen in connection with the application of the new tax allowance system. The main issues can be categorized as either operational (i.e., related to IRS data, methodology, calculation of allowances, and adjustments), or policy-related issues (i.e., tax treatment of U.S. and non-U.S. staff, equity, and safeguard provisions).

The specific issues discussed in the following sections are related to the operational aspects of the average deduction system. The staff intends to begin work forthwith on a further report that will deal with important issues concerning the equitable treatment of staff, including the impact of recent tax law changes on the taxation of nonorganization income of U.S. and G-IV staff members and their families, and the impact

of the average deduction system on net pay of U.S. staff hired since January 1, 1980. The issues to be examined could indicate revisions in the tax allowance system itself. However, this report is intended to review the operation of the system, not to explore new systems.

1. <u>IRS average deduction data</u>

Use of IRS data on average deductions has posed two types of problems for the organizations' tax allowance system. The first is that the national average deductions for each income bracket do not increase smoothly as one goes from lower to higher income brackets. The second is that they are available only with a three-year lag.

a. <u>Smoothing of IRS data</u>

To avoid discontinuities in the tax allowance and net salary calculations, the tax consultants have used a smoothing technique to ensure that an increasing progression of average deductions at increasing levels of adjusted gross income is maintained. Generally, more smoothing is required in the upper-income brackets. The smoothing is achieved by fitting a line between the high and low points, using a midpoint methodology to remove outlying points. In addition, the overall variance between the original and smoothed deductions is analyzed to ensure that no bias toward higher or lower deductions is created. While this form of fitting a line is not wholly satisfactory, it seeks to retain as many actual observations as possible.

b. <u>Three-year lag</u>

(1) The fact that the data used in the average deduction system and in netting down comparator salaries are available only with a three-year lag means that the tax allowances paid to U.S. staff, as well as the indicated net salaries for all staff, reflect developments in the economy (e.g., changes in interest rates) and in the U.S. tax code with the same three-year lag. Consistent with the decisions of the two Executive Boards, the premise of the organizations in implementing the average deduction system has been that, apart from the smoothing procedures discussed above, adjustments to the IRS data on deductions should be made by the organizations only when the need for them is clear and compelling. In some cases, there has been a clear and compelling need for adjustments, and these have been made on the advice of the consultants. In other cases, where the extent of the required adjustment would have been quite unclear, no adjustments have been made.

(2) The fact that the system reflects developments in the economy with a three-year lag means that movements in the organizations' net pay scales, and in the actual after-tax income of U.S. staff members, will not be closely synchronized with those of U.S. comparators; these effects should, however, tend to average out over time. Changes in the tax code

can present more difficult problems. As noted in the next section, the changes introduced by the Tax Reform Act of 1986 were so far-reaching that the system could not have been credible if they were not taken into account. Consequently, in line with the policy of making adjustments when there is a compelling need to do so, the adjustments set forth in Section V have been incorporated in the average deduction system. 1/ It remains the intention of the organizations to continue to adjust IRS data only when there are clear and compelling reasons to do so, and Executive Directors will be kept informed of any such adjustments.

2. Average deduction system methodology

Experience in the implementation of the average deduction system has brought to light two problems concerning the basic methodology of the system. The first concerns the treatment of nonpay items, and the second relates to the use of all-returns IRS data for lower-salaried staff.

3. Nonpay income items

a. When the new tax allowance system was introduced, it was decided that the level of deductions used in calculating tax allowances should take into account all of the staff member's income from the Bank or Fund. 2/ This decision reflected the fact that the IRS statistics on adjusted gross income include all types of taxable income.

b. Upon further consideration, however, it would seem that both symmetry and internal equity require that nonpay income items, which are not taken into account in netting down comparator salaries, should also not affect the average deductions assumed for U.S. nationals in the tax allowance calculations. At present the only nonpay items that are taxable for U.S. nationals and affect average deductions are the cost of spouse travel on points and, for high-income staff, the imputed income from the organizations' group life insurance.

c. At present, for example, when a staff member uses his benefits under the spouse travel policy, his gross income in that particular year will be higher than his normal gross income by the cost of the spouse travel plus the amount by which this cost is grossed up. The average deductions used for that year will reflect this higher gross income, and

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1/ In the Bank, the adjustments are already being used as the basis for quarterly payments to U.S. staff. In the Fund, the adjustments will be put into effect for the full year in connection with the payment to U.S. staff for the fourth quarter of 1987.

2/ An exception was made in respect of one-time severance payments, such as termination grants and payments of accrued annual leave, which it was decided should not be taken into account in determining the level of deductions used in calculating allowances for the final year of employment.

the tax allowance will be based on the corresponding higher assumed deductions. This is inconsistent with the compensation system, because the deductions used in the calculation of his tax allowance will be higher than the deductions that were used in netting down comparator salaries at his pay level. It is also inconsistent with internal equity, as the U.S. national--but not the non-U.S. staff member--will have his actual after-tax income reduced as a result of having used the spouse travel benefit. A similar analysis applies with respect to tax on imputed income from the group life insurance schemes.

d. It was for these same reasons that the Fund decided in 1984, and the Bank in 1986, to exclude from income for purposes of determining the assumed average deductions the difference between the employee and the self-employed Social Security tax, which is reimbursed by the organizations. The Bank also decided in 1986 to exclude spouse travel and imputed income from the group life insurance from the calculations. It is now intended to exclude these two remaining nonpay income items from Fund income for purposes of determining the level of average deductions to be used in the tax allowance calculations. The total annual cost of the changes with respect to spouse travel and to imputed income from group life insurance is expected to be negligible (less than US$2,000).

4. All-returns average deduction data and lower-salaried single staff

a. IRS data are available by type of return filed, i.e., single, married filing jointly, head of household, etc. In addition, the data are published in aggregate form on an all-returns basis. The question of which IRS series to use was considered carefully at the time of the introduction of the average deduction system, and the all-returns basis was chosen for several reasons: it was simple; it was based on the largest possible sample; and it provided a close fit with the deductions actually reported by both married and single staff members in the survey of their 1976 tax returns. However, certain changes in the U.S. tax code since the survey year now call into question the appropriateness of using all-returns data for lower-salaried single staff.

b. The average deductions reported by IRS include both taxpayers who claim the standard deduction and those who itemize. In 1973, the base data year used for comparison with the 1976 staff survey data, the maximum standard deduction was the same (US$2,000) for single taxpayers and for married taxpayers filing jointly (Table 6). In 1976 the standard deduction for both single and married filing jointly was 16 percent of adjusted gross income, with certain maxima and minima that were higher for married filers than for single filers. From 1979 through 1984, however, the tax code established standard deductions of US$2,300 for singles and US$3,400 for married couples filing jointly. It is this introduction of higher standard deductions for marrieds than for singles that calls into question the use of the all-returns data for lower-salaried single staff.

Table 6. Evolution of Standard Deductions and Personal Exemption, 1973-90

	Standard Deduction		
	Single	Married (Filing jointly)	Personal Exemption
1973	15 percent of AGI 1/ (minimum 1,300) (maximum 2,000)	15 percent of AGI 1/ (minimum 1,300) (maximum 2,000)	750
1974	15 percent of AGI 1/ (minimum 1,300) (maximum 2,000)	15 percent of AGI 1/ (minimum 1,300) (maximum 2,000)	750
1975	16 percent of AGI 1/ (minimum 1,600) (maximum 2,300)	16 percent of AGI 1/ (minimum 1,600) (mazimum 2,300)	750
1976	16 percent of AGI 1/ (minimum 1,700) (maximum 2,400)	16 percent of AGI 1/ (minimum 2,100) (maximum 2,800)	750
1977	2,200	3,200	750
1978	2,200	3,200	750
1979	2,300	3,400	1,000
1980	2,300	3,400	1,000
1981	2,300	3,400	1,000
1982	2,300	3,400	1,000
1983	2,300	3,400	1,000
1984	2,300	3,400	1,000
1985	2,390	3,540	1,040
1986	2,480	3,670	1,080
1987	2,540	3,760	1,900
1988	3,000	5,000	1,950
1989	Indexed	Indexed	2,000
1990	Indexed	Indexed	Indexed

1/ Adjusted Gross Income.

c. In 1984, the majority of U.S. taxpayers with adjusted gross incomes below US$25,000 claimed the standard deduction. For those levels between US$25,000 and US$40,000, the proportion of taxpayers claiming the standard deduction remains important but declines steadily as income rises; it drops off sharply for adjusted gross incomes above US$40,000. Because of the effect of the large percentage of taxpayers claiming a standard deduction below an adjusted gross income of $40,000 and because of the large difference between the standard deduction for married taxpayers and single taxpayers, single deductions are well below the all-returns deduction statistics that are used in the tax allowance calculations. This finding adds weight to the rather frequently voiced complaint of lower-salaried single staff that their assumed deductions are too high, resulting in consistently lower tax allowances than the amounts of tax they pay. In fact, the tax consultants have determined that at the lower-salary levels the all-returns deductions exceeded the single deductions by US$600 to US$1,000, or from 15 percent to 30 percent of the all-returns deductions. As a result, assuming that the staff member's actual deductions are equal to the IRS average deductions for a single taxpayer at the staff member's income level, the typical single staff member at the lower levels had to add to his 1986 tax allowance from his own resources about US$250 to meet his actual tax liability. This problem, if unaddressed, would be compounded by the Tax Reform Act, because the difference between the standard deductions for singles and marrieds would rise to US$2,000 in 1988, compared with US$1,100 in 1983.

d. Although there would appear to be a good argument for using a single average deduction schedule in calculating tax allowances for lower-salaried staff, there are also strong statistical reasons not to adopt this procedure for all staff. As noted above, even the all-returns data do not produce a smooth relationship between average deductions and adjusted gross income. Sharp upward and downward movements in average deductions as income increases are a more serious problem in the higher brackets. This problem would be greatly accentuated by using the single-returns data, because single taxpayers account for less than 10 percent of the returns filed with an adjusted gross income above US$40,000. An even more fundamental problem is posed by the fact that the relationship between married and single deductions, within the same adjusted gross income range, shifts from year to year in ways that are difficult to explain and certainly impossible to anticipate. Given these statistical problems, the use of the single deduction series for calculating tax allowances for single staff, other than those in the lower brackets where standard deductions weigh heavily, would subject staff to an unnecessarily high degree of variability in, and uncertainty about, their organization income. Moreover, there would seem to be no advantage to the organizations from using separate schedules for the two groups; despite erratic movements between brackets and between years, at the higher salary levels the two series, on average and over time, do bear a very similar relationship to adjusted gross income.

e. In light of the foregoing, it is proposed that the Bank and Fund use single average deduction schedules in calculating tax allowances for single staff below a specified adjusted gross income, which would have to be reassessed periodically. To avoid discontinuities, the tax consultants would need to prepare separate smoothed series for singles, with the singles and the all-returns series converging at the specified adjusted gross income. This procedure should not pose difficulties, because the underlying data do converge. It is considered that this approach would go some way to addressing the problem that has arisen regarding tax allowances for lower-salaried staff while, at the same time, being simple to administer and easy for staff to understand.

f. The review also showed that for each year (1982-84) at an adjusted gross income above US$40,000, the single and all-returns schedule tended to converge as taxpayers claiming the standard deduction declined. It is proposed that beginning with the 1988 tax allowance calculations, the two series be smoothed to converge at US$40,000. This level should be reviewed and the appropriate changes made in the future as the percentage of taxpayers claiming the standard deduction at various levels changes.

5. Tax allowance on Social Security reimbursement

a. Under the U.S. Social Security System, employees and employers make equal contributions to the system. In 1987, for example, the employee and his employer are each subject to a Social Security tax of 7.15 percent of the employee's gross earnings, up to a maximum tax for each of US$3,131.70. However, because international organizations are not subject to U.S. taxes, including Social Security, U.S. nationals employed at the Fund and the Bank are classified as "self-employed" for purposes of Social Security taxation, and the organizations reimburse U.S. nationals for the difference between the Social Security tax they would pay if they were employed elsewhere and the higher self-employed rates that they pay because they are employed by the organizations. In 1987 the self-employed Social Security tax is 12.3 percent of gross earnings from employment up to a maximum tax of US$5,387.40. Because the Social Security reimbursement paid by the organizations is taxable income to the U.S. national, it is included in net income and grossed up in the tax allowance calculation. The organizations pay, therefore, not only the excess Social Security tax but also income tax on that tax.

b. Prior to 1984, the self-employed Social Security tax rate was 150 percent of the employee rate. The Social Security Amendments Act of 1983 substantially altered the provisions for self-employed persons. Under that Act the self-employed rate is being increased each year until, beginning in 1990, the self-employed rate will be 15.3 percent and equal to the combined employee and employer contribution. Beginning in that same year, however, those who pay Social Security at the self-employed rates will be able to take one half of the Social Security tax paid as an adjustment to their gross income in arriving at taxable income for income tax purposes.

This provision was introduced to put self-employed persons on the same footing with respect to income tax as employees generally, since the employer's contribution to Social Security is not deemed to constitute taxable income to the employee. It is proposed that, when this provision takes effect in 1990, the organizations take the corresponding adjustment to income into account in calculating income tax allowances. 1/ This will mean, in effect, that the organizations will pay no income taxes on the Social Security reimbursement paid to U.S. nationals, because no income tax liability will accrue therefrom. The organizations would, of course, continue to reimburse the full excess Social Security tax paid by staff as a result of the tax status of the organizations.

6. Proposed change in the safeguard calculation

In calculating staff members' tax allowance during their final year of employment, the organizations do not take certain one-time severance payments, such as accrued leave and any termination grant, into account in determining the deductions to be assumed for that year. It is proposed to treat in the same way any safeguard payment received in the final year of employment with respect to a shortfall in the tax allowance for the preceding year. Although it is true that in any year the inclusion of the safeguard payment in income for purposes of determining the average deduction tends to bias upward the deduction level assumed, the safeguard system itself would in years prior to the final year fully protect the staff member from any underreimbursement owing to this factor.

V. Implications of Tax Reform Act of 1986

1. The Tax Reform Act of 1986 is generally considered to be the most far-reaching set of tax code changes ever enacted by the U.S. Congress. While the Act is intended to be revenue-neutral overall, it was also designed to

1/ Alternatively, self-employed persons will from 1990 be allowed the option, in calculating their Social Security tax due, of excluding from income 50 percent of the normal combined employee and employer rate. This option will be beneficial to those whose marginal income tax rate is less than 15.3 percent. Since the bottom marginal rate under the Tax Reform Act of 1986 is 15 percent, this could result in a benefit for lower-salaried staff equal to 0.3 percent of that part of income subject to a marginal income tax rate of 15 percent, i.e., a maximum benefit of US$89. However, so long as Maryland, Virginia, and the District of Columbia continue to follow IRS practice in determining taxable income, this option would not be taken by any staff member residing in those jurisdictions. It is, therefore, proposed that this option be ignored by the organizations.

produce a major shift in the incidence of the overall tax burden. It has been estimated that the Act will reduce individual income taxes by US$120 billion over its first five years, offset primarily by increases in corporate taxes. 1/ This section considers the implications of the Tax Reform Act for the organizations' tax allowance system. Two points should be noted in this connection. First, the numerous provisions of the Act have different effective dates; some provisions will be phased in and others will be effective on different dates between January 1, 1987 and January 1, 1990. In this connection, the Bank and Fund can only plan to incorporate changes to the average deduction system as they occur, because there remains the possibility that the Tax Reform Act's transition schedules and effective dates may be revised under future tax legislation. The second point is that the tax allowance system is designed to take account automatically of year-to-year changes in tax rates, exemptions, and other provisions in the U.S. personal income tax system. Therefore, certain changes brought about by the tax reform can be readily reflected in the tax allowance system under the current methodology, and the necessary changes are described briefly in Section 2 below. Other implications of the reform on the tax allowance system do involve changes in methodology, and these have been carefully reviewed with the tax consultants and are dealt with in more detail in the subsequent sections.

2. Changes that do not require adjustment to methodology

a. Reduction in personal income tax rates

(1) The new law has retained the four different filing schedules discussed earlier, i.e., married filing jointly, single, head of household, and married filing separately. The applicable rates have, however, been reduced substantially in all cases. Under prior law each schedule had 15 tax brackets, with a top marginal rate of 50 percent. In 1987--a transition year--there will be 5 brackets, with a top marginal rate of 38.5 percent. Beginning in 1988 there will be only 2 brackets of 15 percent and 28 percent. 2/

1/ It should be noted that the Tax Reform Act could also have the effect of raising state income taxes, although by less than the reduction in federal taxes. This reflects the fact that many states, including Maryland, Virginia, and the District of Columbia, base their allowed deductions on those permitted on the federal return. Since the Act reduces allowable deductions, income tax revenues will rise in such states unless they enact offsetting tax cuts.

2/ In 1988, the effective marginal rate will be 33 percent for gross income levels between US$43,150 and US$100,480 for single staff with no dependents and for gross income levels between US$71,900 and US$192,930 for married staff with two children.

(2) Although the top tax bracket will be 28 percent when the law is fully in effect, many taxpayers and many U.S. staff will actually be paying federal income tax at marginal rates of 33 percent. This reflects two phase-out provisions incorporated in the law. First, the impact of the 15 percent tax bracket is phased out for higher-income taxpayers by applying a 5 percent surcharge on top of the 28 percent marginal rate until the point is reached where the average tax rate paid on taxable income is 28 percent. At that point, a second 5 percent surcharge is applied to phase out the effect of personal exemptions for self, spouse, and dependents. Only thereafter is the marginal rate truly 28 percent.

(3) The tax rate reductions pose no methodological problems, and in accordance with established procedures of adapting to tax changes as they occur, they are being reflected in the calculation of tax allowances. In the Bank, the quarterly payments to staff are based on the reduced tax rates; in the Fund, the change will be reflected in the final quarterly payment for the year.

b. Increase in personal exemptions

(1) One personal exemption each may be claimed for the taxpayer, spouse, and each eligible dependent. The personal exemption has been raised from US$1,080 in 1986 to US$1,900 in 1987, to US$1,950 in 1988, and to US$2,000 in 1989. Thereafter, it is to be indexed for inflation. The sharp increase in the personal exemption will, ceteris paribus, result in somewhat larger tax cuts for larger families. However, as described above, a 5 percent surcharge is applied to higher-income taxpayers until the benefits of the personal exemptions have been phased out.

(2) The change in the personal exemption also poses no methodological problems and is being taken into account in the calculation of tax allowances.

c. Standard deduction

The standard deduction that can be claimed by taxpayers who do not itemize deductions has been raised for all four types of return, although it has been raised proportionately more for married taxpayers, whether they file jointly or separately, and for heads of households than it has for single taxpayers. The standard deduction for single taxpayers is being increased from US$2,480 in 1986, to US$2,540 in 1987, and to US$3,000 in 1988. The deduction for married taxpayers filing jointly will rise from US$3,670 in 1986, to US$3,760 in 1987, and to US$5,000 in 1988 (Table 6).

(1) The organizations have, since the introduction of the average deduction system, followed the practice of calculating tax allowances on the basis of either the current year's allowable standard deduction or the three-year lagged data on average deductions, whichever is higher. Because the current procedures already take into account increases in the standard deduction, no further modification of the system in this respect is considered to be necessary.

(2) Tax allowances are calculated on the basis of published IRS average deduction statistics for the all-returns group of U.S. taxpayers, with actual allowances paid to staff members reflecting the state income taxes according to where they reside rather than the national average for state income taxes. Until 1987, the adjustment for actual state taxes has been the only adjustment made to the IRS data on average deductions since the adoption of the average deduction system. 1/ When the system was implemented, it was recognized that changes in tax codes could affect current deductions which would not be reflected in three-year-old IRS statistics. It was agreed, therefore, that when changes appeared significant the Bank and Fund would consider whether any adjustment was warranted. Since the average deduction system was adopted, there have been several changes in the U.S. tax laws, including the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, and the Deficit Reduction Tax Bill of 1984.

(3) Following the changes in U.S. tax laws, the tax consultants evaluated the probable effects of the tax changes on the operation of the average deduction system to determine if adjustments were warranted. The tax consultants have been very cautious in recommending any adjustment to the IRS statistics or to the calculation of tax allowances. With respect to the IRS deduction statistics, the position of the tax consultants has been that changes made in the kinds or amounts of tax deductions allowed to U.S. taxpayers generally have not been substantial enough to cause the three-year-old data to be unrealistic, and adjustments that might have been contemplated would have been necessarily arbitrary given the absence of information on U.S. taxpayer behavior patterns under any new provisions. However, the tax consultants have reviewed the Tax Reform Act of 1986 and concluded that certain adjustments to the IRS data now appear to be warranted. These are explained below.

1/ The average deduction statistics are provided by the IRS at income intervals of US$1,000, US$2,000, US$5,000 or US$10,000 depending on income level. The IRS data are refined by the tax consultants to produce income intervals of US$500 and, at the same time, they are smoothed to minimize erratic changes from interval to interval.

3. Changes requiring adjustment

a. Itemized deductions

The Tax Reform Act will reduce significantly allowable itemized personal deductions. Some deductions have been eliminated immediately, others are being phased out, and still others are being sharply curtailed. Because the IRS data on which the average deductions are based are available only with a three-year lag, the question of how to take these changes into account poses the only important methodological problems in adapting the tax allowance system to the Act. For example, the most recent data available in 1987 will reflect average deductions in 1984. It is, therefore, necessary to make adjustments to the 1984 data for the system to reflect adequately the deductions that can actually be claimed in 1987. The IRS data are, however, available in sufficient detail, by US$1,000 income brackets, to permit reasonable adjustments to be made. The changes in itemized deductions introduced by the Tax Reform Act are discussed below and, where required, the new method of adjustment is described and discussed.

(1) State sales taxes

Effective in 1987, state sales taxes can no longer be taken as an itemized deduction. Since data are available on the average sales tax deduction claimed in 1984 in each income bracket, this change can easily be taken into account. The average state sales tax deduction claimed will be subtracted from the average deduction for each adjusted gross income level.

(2) Medical deduction

Previously taxpayers could itemize medical expenses to the extent that those expenses, excluding any amounts for which they were reimbursed under a medical insurance plan, exceeded 5 percent of their adjusted gross income. The Tax Reform Act raised that floor to 7.5 percent of adjusted gross income. No information is available on the dispersion of ratios of medical deductions to adjusted gross income for those who did itemize deductions over the 5 percent floor, and there is, therefore, no way to make a precise adjustment for this change. However, on the basis of the most recent IRS statistics, the average medical deduction of those who itemize medical expenses would exceed 7.5 percent of mean adjusted gross income in very few brackets. Because of this, and because only under the most exceptional circumstances would any staff member covered by the organizations' medical plans have out-of-pocket medical expenses in excess of 7.5 percent of adjusted gross income, it is proposed that during the next three years the organizations not take medical deductions into account in calculating average deductions. The amounts involved are not large. The average 1984 deduction before any adjustment is about US$200 for adjusted gross incomes of US$50,000-55,000 and about US$600 for those of US$100,000-105,000.

(3) Interest deductions

(a) The changes in provisions regarding interest deductions are likely to have the biggest impact on the overall level of deductions. These changes are also the most complicated. In terms of IRS provisions, personal interest deductions can be divided into three categories: mortgage interest, consumer interest, and investment interest. The latter would include, for example, money borrowed to buy stocks or other portfolio investments. The IRS data on average deductions, however, distinguishes only between mortgage interest and other interest, i.e., it does not provide a breakdown of consumer and investment interest. Previously, deduction of any amount of consumer interest was permitted, and the deduction of investment interest of up to US$10,000 plus the earnings on such investments was also allowed. When the new law comes fully into effect in 1991, no deductions will be allowed for consumer interest and an investment interest deduction will be permitted only up to the amount of net investment income. In the intervening years these deductions will be phased out. In 1987, 65 percent of consumer interest will be deductible as will 65 percent of the amount by which investment interest exceeds investment income (up to a maximum of US$6,500, i.e., 65 percent of US$10,000). These percentages will be 40 percent in 1988, 20 percent in 1989, and 10 percent in 1990. In 1987, 1988, and 1989 the Bank and Fund will be adjusting the IRS statistics for nonmortgage interest by reducing them by the corresponding percentages. From 1991 onward, only mortgage interest deductions would be taken into account in calculating average deductions to be used for tax allowances and in netting down comparator salaries. Although interest on borrowings used to purchase investments will continue to be deductible up to the amount of earnings on such investments, it would not be appropriate to treat such interest as deductions against organization income.

(b) The Tax Reform Act maintains the deduction for mortgage interest on a first and second home, and as a result no adjustment is required to reflect the change in the tax law.

(4) Moving expenses

(a) Previously, moving expenses required by one's employment, i.e., either to take up a new job or in connection with a reassignment, could be taken by the taxpayer as an adjustment to income. Beginning in 1987, such moving expenses will be an itemized personal deduction. The organizations provide settling-in allowances to new staff recruited from outside the Washington area and resettlement allowances to such staff when they leave the organizations. Similarly, allowances are paid to staff on assignment overseas or on return to Washington. These allowances, which are specified in terms of a certain number of weeks' salary depending on marital status and number of dependents, are taxable income for U.S. staff. The policy of the organizations to date has been to assume in calculating

the staff member's tax allowance that he is able to claim an adjustment to income equal to the settling-in or resettlement allowance that he received. 1/ Certain other expenses, such as airfares and shipment of effects, are paid directly or reimbursed by the organizations and neither constitute taxable income nor can be taken as an adjustment to income by the taxpayer.

(b) Because moving expenses are directly related to organization employment, it is proposed to continue the present practice notwithstanding that such expenses are now an itemized deduction rather than an adjustment to income. In years in which such an allowance was actually paid to a staff member, the organizations would assume a personal deduction for moving expenses equal to the allowance received. Consistent with this approach, the organizations would not take into account the average deduction for moving expenses claimed by U.S. taxpayers generally.

(5) Other miscellaneous itemized deductions

(a) All deductions other than medical, state and local taxes, interest, charitable contributions, casualty and theft losses, and moving expenses are classified as other miscellaneous deductions. Under the Tax Reform Act, expenses that fall in this category are deductible only to the extent that the total of such deductions exceeds 2 percent of adjusted gross income. The changes introduced by the Act with respect to these other miscellaneous deductions pose two problems for the organizations' tax allowance system.

(b) The first problem is how to take account of the new 2 percent of adjusted gross income floor during the three years until its impact is reflected in the lagged IRS data. This is similar to the problem posed by the increase in the floor for medical deductions discussed above. Again, the only information available is the average amount of miscellaneous deductions claimed by taxpayers in each income bracket in 1984, and these data show that in very few cases does the deduction claimed exceed 2 percent of adjusted gross income. It is, therefore, proposed that during the three years until the IRS data reflect the impact of this floor, the organizations not take into account miscellaneous itemized deductions in the average deductions used for calculating tax allowances and netting down comparator salaries.

(c) The second problem relates to employee business expenses. Previously, employee business expenses were an adjustment to income. Beginning in 1987 they are to be included in miscellaneous deductions subject

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1/ Resettlement allowances paid upon retirement are not allowed as an adjustment to income and the organizations do not assume such an adjustment in calculating the tax allowance.

to the 2 percent floor. Deductible employee business expenses consist primarily of business travel expenses, e.g., airfares, hotels, and out-of-town meals, that are not reimbursed by the employer. Since the organizations fully reimburse expenses for approved travel, staff members would generally not be entitled to claim any deductions under this category. It is, therefore, proposed--as with moving expenses--that the organizations not take the employee business expense item into account in the average deductions used either for calculating tax allowances or for netting down comparator pay. Because deductions for employee business expense will not be reflected as an itemized deduction until 1990, when the 1987 IRS data are available, no adjustment will be necessary before that time. Thereafter, the tax consultants will review the effect of the changes and make a recommendation as to whether and how to take account of these deductions.

b. Adjustments to income

(1) Two-earner adjustment

From 1982 to 1986 the U.S. tax code permitted an adjustment to income for two-earner families filing a joint return. The adjustment allowed was 10 percent of the earned income of the spouse with the lower earnings, up to a maximum adjustment of US$3,000. The organizations took this adjustment into account in the tax allowance calculations for staff members whose spouses had earned income. The specific methodology adopted by the Bank and Fund allocates one half of the allowable adjustment to the staff member's organization income. The adjustment is applicable only where the tax allowance is calculated on the basis of married filing jointly. This adjustment has been eliminated by the Tax Reform Act and the effect of this change will be offset, at least in part, by the impact of lower tax rates on the tax allowances paid to staff with working spouses. In addition, it will be necessary to adjust the three-year lagged data relating deductions to adjusted gross income to take account of the fact that this adjustment is no longer available. IRS data permit the organizations to make the necessary adjustment to the adjusted gross income associated with each deduction level.

(2) Individual Retirement Accounts

From 1982 to 1986 taxpayers were permitted to defer taxation on up to US$2,000 of earned income for each wage earner (US$2,250 for one-income families). Amounts contributed to an Individual Retirement Account were an adjustment to income in the year of the contribution and taxable income in the year (after age 59 1/2) they were withdrawn. Under the Tax Reform Act, adjustments to income for an IRA are permitted only if (1) neither the taxpayer nor the spouse belongs to a qualified pension plan, or (2) adjusted gross income is less than US$35,000 (US$50,000 for married couples filing jointly). Because the organizations' staff retirement plans are qualified plans, no staff member with an adjusted gross income

above these levels--i.e., above a net salary level of about US$28,000 for a single staff member--can take an adjustment to income for an IRA contribution. A single taxpayer whose adjusted gross income is below US$25,000 (US$40,000 for married filing jointly) can take a full IRA adjustment as under prior law. In between these income levels, the permitted IRA adjustment is eliminated.

(3) It is proposed that the adjusted gross income for each deduction level be raised by the average IRA adjustment at that income. It is, moreover, proposed that this adjustment be made at all income levels. The rationale for making the adjustment at all levels is not the changes introduced by the Tax Reform Act, but rather that such an adjustment should have been made in any case. Unlike a personal deduction, an IRA adjustment does not eliminate the tax liability on that income; rather, it only defers it. By basing the tax allowances on adjusted gross income after adjustment for IRAs, the organizations implicitly benefit from part of the reduction in taxes that occurred in the year of an IRA contribution, but with no corresponding provision for the organizations to pay a part of the tax liability on IRA amounts withdrawn. The IRS statistics will permit the adjustments to be made at each adjusted gross income level.

VI. Communications with Staff

The Working Group recognized that much greater efforts must be made in communicating to the staff the provisions of the tax allowance system and its implications in individual cases. Because the income tax provisions are complex, the tax allowance system is also complex. It is, therefore, essential that carefully prepared communications be presented to the staff, supplemented by personal contacts. In addition to better written materials, including illustrative calculations where appropriate, the Working Group considers that presentations explaining the broad policy provisions would be useful. Also, the development of an interactive computer program that could be used by staff to calculate actual tax liability should be considered. The Working Group recommends the development of better communication materials as soon as possible, especially in light of the current and future changes that result from tax legislation.

Attachment 3

World Bank Group Staff Association

1818 H Street, N.W., Washington, D.C. 20433, U.S.A. • Telephone: (202) 477-1234 • Cables: INTBAFRAD

TO: Mr. Ian M. Hume, PERCO

FROM: Christopher Redfern, Chairman

EC87-237
October 20, 1987

SUBJECT: Five-Year Review of Average Deductions Systems (ADS)

We have reviewed the above paper and are in broad agreement with the approach and recommendations, as far as they go, but believe that many important issues remain unaddressed. (Our Working Group's comments were provided in a memo of October 2, addressed to Mr. Jones and were discussed with him and Mr. Russell).

We continue to believe that the Bank should strive to ensure to the greatest degree possible equal net pay for all staff doing equal work. In this regard, it is curious that the paper makes no mention of the efforts to get the U.S. to accede to the Convention on Privileges and Immunities, which would exempt U.S. nationals from income taxes and thus eliminate the need for a costly tax allowance/reimbursement system. It was one of the recommendations of the Kafka Committee that these efforts should continue to be made, and we think the report should discuss the efforts that have been made in this regard in the context of the five-year review.

The paper suffers by not addressing the major equity problem that has emerged in implementing the average deductions system (ADS), namely that it has left large numbers of staff, apparently concentrated among lower-level and younger staff, with tax allowances that are substantially less than their tax obligations attributable to Bank income. To some extent, this is an outcome that is inherent in an allowance (as distinct from a reimbursement) system, and was one of the reasons that the Staff Association opposed its introduction. Our recent 1986 survey of staff indicated that the ADS had, in fact, left even more staff than we had feared with substantial shortfalls between their tax allowances and their actual taxes. We do not think that when the ADS was instituted the Board can have intended that U.S. staff should suffer such financial harm. We might also note that during this same period, in addition to Federal and state income taxes, the burden borne by U.S. staff for social security taxes has also risen sharply.

Unfortunately, the five-year review has not dealt with these issues of internal equity. Moreover, it seems that because of the three-year lag in obtaining data from the IRS on average deductions, matters will get worse over the coming three to four years, as the provisions of the 1986 Tax Reform are phased in. Our Tax Working Group has made some positive suggestions which, in the absence of more thoroughgoing changes in the basic tax allowance system, would at least limit the amounts that staff spend from their net income to pay income taxes attributable to Bank income. We urge that these proposals be given serious consideration.

There are also a number of issues relating to the implementation of the so-called "safety net" provisions available to U.S. staff hired before January 1980 that have not been addressed in the paper. In principle, the safety net fully protects eligible staff from under-reimbursement resulting from the use of average deductions. In practice, it has been utilized by relatively few Bank staff. In our view, this has been largely due to misunderstanding of the scheme by staff eligible to apply and concern over the ability of the Bank to preserve the confidentiality of the personal information that must be provided in applying for safety net payments. The basis for such concern was regrettably confirmed by the Lamson-Scribner case which was decided in the Tribunal recently. The Bank's Tax Office simply must do a better job of informing staff about the safety net and assuring them of its confidentiality.

There are also some issues related to the timing of safety net payments that need to be addressed. These are peculiar to the Bank because of the differences between the manner in which the Bank and Fund make their tax allowance payments during the year. As a result, the Fund provides the equivalent of estimated safety net payments during the year in which the obligation accrues. That the Bank does not do this may entail increasing hardship for affected staff as a result of the U.S. Tax Reform Act of 1986.

There is also a need to resolve the calculation of safety net payments for part-year staff that was raised in the Lamson-Scribner case. We have, of course, been pursuing this matter with you separately from the five-year review and look forward to hearing from you further at your convenience, before other staff may be driven to litigation following the Lamson-Scribner example. At this time, we simply wish to indicate our view that, legal questions not-withstanding, annualizing Bank income for safety net calculations (as is done in the regular tax allowance) is an inherently better and fairer approach. Moreover, the Fund has

consistently followed this approach. We cannot see any justification for the two institutions' providing different tax allowances to staff in the same situation: the two institutions' tax allowance policies were clearly intended under the Kafka system to be identical. It is hard to square the present difference of methodology in this case with the principle of parallelism (no matter how you define the latter).

Finally, we strongly support the paper's recommendations to strengthen communications with staff on tax allowances, but we wonder whether the extent of the communication problem is fully appreciated. Most U.S. staff do not know what their net salary equivalents should be, or how to go about finding out. Many staff, particularly at lower incomes, scramble to pay out of pocket taxes which, each April, they are surprised to discover they still owe. What is needed is a system whereby any U.S. staff member can readily obtain an estimate of his gross and net Bank income and have the calculations explained in a simple and clear manner. At present, neither the tax allowance statements nor the Bank's other written materials accomplish this. The suggestion of a PC program that would calculate taxes and tax allowances is a good one, but more needs to be done.

Because the five-year review has so far failed to address these important issues, we believe it is important to establish and communicate to staff a definite time-table for the remaining phases of the joint review which would lead to their effective correction.

cc: Mr. W.A. Wapenhans
Mr. W.J. Cosgrove
Mr. James Jones
~~Mr. ... Russell~~
Ms. M. Haug
Ms. S. Lawrence
Mr. J. Katz
Mr. J. Sopher
Mr. J. Vincent-Smith
Mr. J. Berengaut

November , 1987

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Subject: Review of the Average Deduction System and Proposed Modifications Resulting from the 1986 Tax Reform Act

I. Introduction

1.1 When the Bank and the Fund commenced operations, the two organizations established a tax reimbursement system designed to compensate those staff members who were subject to national taxation on their salaries. 1/ The overwhelming majority of staff members covered by the system were--and are--U.S. nationals. The system for reimbursing staff members for taxes remained the same, except for minor changes, from 1948 until 1979. That system provided for the computation and reimbursement of income taxes due, based on (i) the staff member's income received from the organization, (ii) the staff member's marital status, (iii) the number of exemptions to which the staff member was entitled, (iv) the staff member's tax filing status, (v) the amount of spouse income, if any, to determine whether to take advantage of the split-income provision of the U.S. tax code, (vi) applicable state or D.C. taxes, and (vii) the standard deduction applicable.

1.2 In 1979, the Joint Committee on Staff Compensation Issues (the Kafka Committee) considered a number of systems of tax reimbursement, or tax allowances, and concluded that the major elements of the then-current system should remain the same, except that the standard deduction assumed

1/ Attachment I sets out an excerpt from the 1979 Report of the Joint Committee on Staff Compensation Issues that describes the background to the system of tax allowances in the Fund and Bank.

under the system would be replaced by the average deduction. 1/ Average deductions are reported by the U.S. Internal Revenue Service (IRS) for all U.S. taxpayers by income level. Because the system is based on averages, it accepts that U.S. staff members will have deductions which are more or less than the level of the average. It is important, however, to ensure that the tax allowances paid to U.S. staff are reasonably related to their tax liability on income from the Bank or Fund, and that they are based on fairly realistic average deductions. Since the new system was implemented, each year the Bank/Fund tax consultants, Arthur Andersen & Company, have reviewed the average deduction statistics provided by the IRS. They have also reviewed changes in U.S. tax laws and reported on the impact of those changes on the tax allowance system. In addition, annual reports have been made to the Executive Boards for each year beginning with 1980; those reports have reviewed the operation of the system, noted any changes in tax laws, and requested approval of the Executive Board when modifications were required. Furthermore, when the present tax allowance system was adopted, it was decided that a more thorough review of its operation would be conducted at the end of a five-year transition period.

II. Joint Bank/Fund Review of the Average Deduction System

2.1 During the past year a Joint Bank/Fund Working Group has conducted a review of the average deduction system with the assistance of Arthur Andersen & Company and in consultation with members of the tax working groups of the Bank and Fund Staff Association Committees.

1/ Recommendations of the Joint Committee on Staff Compensation Issues--Tax Reimbursement, January 1979, p.39.

"6.42 We recommend therefore, that:

(i) the Bank and Fund should adopt an Average Deduction System of tax reimbursement - based on the average deductions claimed by United States nationals generally, with modifications to reflect conditions in the Washington area - with allowance being made for spouse income in the same way as happens under the present system;

(ii) the Bank and Fund, in implementing an Average Deduction System, should search for all means of ensuring more equitable treatment amongst all staff;

(iii) The Bank and Fund should again discuss with the Governments concerned the possibility of their taking the necessary steps to eliminate the burden that results from the taxation by those Governments of their nationals employed in their own countries by the Bank and Fund."

Attachment II sets out the decision taken in 1980 by the Executive Board as a result of the above recommendations.

2.2 The report of the Joint Working Group focused on two main issues:

(a) The operation of the average deduction system since its implementation on January 1, 1980 and the improvements that are recommended in the current methodology; and

(b) the impact of the U.S. 1986 Tax Reform Act and recommended adjustments that stem directly from that Act in the average deductions claimed by U.S. taxpapers generally.

2.3 This paper summarizes the findings and recommendations of the Joint Working Group and discusses the need for additional study of the tax allowance system. A similar paper, has being submitted to the Executive Board of the Fund. The full report of the Joint Working Group is available on request.

III. Findings and recommendations on the operation of the average deduction system

3.1 From an administrative standpoint, the average deduction system has operated smoothly since it was put into effect. During a period in which important changes were made in the U.S. tax regime, it proved possible to incorporate these changes into the tax allowance system without major difficulty. The cost of the system is now about 69 percent of what it would have been had the organizations continued with the system based on standard deductions, and this reduction is in line with the estimate made by the tax consultants when the average deduction system was introduced. The Working Group also examined several specific issues related to the operational aspects of the system during the first five years, and it is recommended that the following minor modifications be adopted.

(a) Nonpay income items

The average deductions that apply under the average deduction system relate to a staff member's total income from the Bank or Fund. There are, however, certain items included in staff members' income that would not be expected to affect the level of their tax deductions. These nonpay income items include spouse travel on points, imputed income for high-income staff from the Fund and Bank group life insurance plans, and the difference between the "employed" and the "self-employed" Social Security tax that is reimbursed by the organizations. The Fund decided in 1984 to exclude the additional Social Security tax from the income on which the calculation of average deductions is based. In 1986 the Bank decided to exclude spouse travel, imputed income from group life insurance, and the reimbursed Social Security tax from the average deduction calculations.

(b) All-returns average deduction data and lower-salaried single staff

The average deduction data reported by IRS include deductions claimed by all taxpayers--married, single, those who itemize deductions, and those who claim a standard deduction. In 1976, when it was decided that the all-returns average deductions for U.S. taxpayers provided a close fit with the average deductions of Bank and Fund staff, the U.S. income tax system varied in important respects from that of more recent years. The major shift stems from changes in the level of the standard deduction. In 1976 the standard deduction was the same for both married-filing-jointly and single taxpayers. Changes in the U.S. tax code between 1977 and 1984 created a significant gap between the standard deduction for married-filing-jointly and single taxpayers. Under the Tax Reform Act of 1986, the difference between the standard deduction for married and single taxpayers will be US$2,000. The majority of U.S. taxpayers claim a standard deduction at adjusted gross incomes below US$25,000. Between US$25,000 and US$40,000, the use of the standard deduction declines steadily, and above US$40,000 fewer than 10 percent of U.S. taxpayers claim a standard deduction. Below an adjusted gross income level of US$40,000, the difference between all-returns average deductions and single average deductions is significant. Because of the high percentage of taxpayers claiming a standard deduction, and because of the gap between the standard deduction for single taxpayers and for married-filing-jointly taxpayers, the all-returns average is no longer representative of average deductions for single taxpayers. Above an adjusted gross income of US$40,000, single deductions tend to converge around the all-returns average. This difference appears to account for a problem voiced frequently by single staff in the lower-salary levels that the "all-returns" average deductions seem too high for their income level and their tax allowances are consistently less than the tax they pay.

It is recommended that with effect from January 1, 1988, an average single deduction schedule be used in calculating tax allowances for single staff below that adjusted gross income where the proportion of taxpayers claiming a standard deduction does not have a significant impact on the average deduction data. In other cases the all-returns average deductions would be used as at present. The level below which single deductions would be used would be reassessed periodically by the tax consultants. It is proposed on the basis of recommendations made by the consultants that tax allowance calculations be based on average single deduction schedules for single staff members up to an adjusted gross income level of US$40,000, where all-returns deductions and the single deductions presently converge. Because of the need for computer programing changes and the need for the tax consultant to prepare new average deduction schedules the proposed change would be implemented in 1988. The cost of adopting this approach for the Bank is estimated at less than $30,000 a year.

(c) Proposed change in the safeguard calculation

In calculating staff members' tax allowances during their final year of employment, the Bank and Fund do not take certain one-time severance payments, such as accrued leave and separation grant, into account in determining the level of income for calculation of the deductions to be assumed for that year. In the final year of employment, it is now proposed to treat any safeguard payment received in the final year with respect to the previous year's tax allowance in the same way as other one-time payments.

IV. Impact of 1986 U.S. Tax Reform

4.1 The U.S. Tax Reform Act of 1986 is considered to be the most far-reaching set of tax changes ever enacted by the U.S. Congress. The majorprovisions of reform will be phased in over a three-year period. The Bank and Fund plan to incorporate changes affecting the average deduction system as they are implemented in the U.S. tax system. However, given the phase-in of the changes and the three-year lag in the average deduction statistics provided by the U.S. Internal Revenue Service, it will be several years before the full impact of the reform on the average deduction system can be fully assessed. In the meantime, with guidance from the tax consultants, the effects of specific changes resulting from the reform will be factored into the annual tax tables prepared by Arthur Andersen & Company for use in calculating tax allowances as well as netting down comparator compensation. The tax allowance system automatically takes account of many provisions in the U.S. income tax system, and certain changes brought about by the tax reform will be reflected in the tax tables used by the organizations. However, when changes in the tax law have a major effect on average deductions or the adjusted gross income, adjustments to the lagged data are required to reasonably approximate the current tax environment. The adjustments recommended by the tax consultants to reflect the reform for the 1987 tax year are described below. These adjustments have been incorporated in the Bank's tax allowance calculations since April 1987 because the Bank pays allowances on a currentbasis during the year. The Fund pays tax allowances for the first three-quarters of each year based on the total tax allowance received the previous year (one fourth of the previous year's total allowance is paid in April, June, and September) and applies the new tax tables to the final payment for the fourth quarter, making any necessary adjustments in that payment.

4.2 The adjustments recommended by the tax consultants for 1987 are:

(a) The Tax Reform Act of 1986 eliminated the two-earner married couple deduction and made the Individual Retirement Account (IRA) more restrictive for taxpayers participating in a qualified pension or profit-sharing plan. After

examining the effect of the IRA and the two-earner deduction on the adjusted gross income (AGI), it was decided that the average deduction system (ADS) should be adjusted to reflect the changes made by the reform. The reform eliminated IRA deductions for married taxpayers with AGIs greater than US$50,000 who participate in an employer maintained retirement plan. The full deduction is allowed for AGI levels of US$40,000 and below, and there is a phase-out between AGI levels of US$40,000-50,000. Since the both organizations have qualified pension plans, a change to the adjusted gross income to reflect the reform was considered appropriate. Similarly as the two-earner deduction was eliminated, the average adjustment for the two-earner deduction and the average IRA adjustment were added to the original IRS adjusted gross income level to arrive at an adjusted level. These AGI levels were then used as the basis to determine IRS average deductions.

(b) The federal average deductions were then adjusted in the following four areas to accord with changes made in the law by the 1986 reform:

Medical Deduction - Since the reform increased the floor for medical deductions from 5 percent of adjusted gross income to 7 1/2 percent, the additional limit was factored into the net average deduction calculations based on the 1984 IRS statistics. The higher floor has essentially eliminated medical deductions and the amounts have been subtracted from the 1984 IRS deduction statistics.

Sales Tax Deduction - Because sales tax is no longer a deductible expense in 1987, the entire average sales tax deduction was subtracted from the IRS average deduction amount.

Interest Expense Deduction - The 1986 reform phases in an elimination of consumer interest expense as an itemized deduction. Owing to the phase-out period of the consumer interest expense deduction, there is a 35 percent reduction in 1987. Thus, 35 percent of the average nonmortgage interest was subtracted from the IRS average deductions in deriving the net average deduction amount.

Miscellaneous Itemized Deductions - The 1986 reform made several changes to miscellaneous itemized deductions. Unreimbursed employee business and moving expenses were moved from above-the-line adjustments to gross income to miscellaneous itemized deductions. In addition, a 2 percent

adjusted gross income floor was included for all miscellaneous itemized deductions except moving expenses. Since the employee business and moving expenses are currently included in the organization's calculations to arrive at the adjusted gross income, it was decided that no adjustments should be made to either the adjusted gross income or IRS deductions for these amounts.

4.3 It is recommended that these adjustments be approved for 1987 tax allowance calculations, and it is further recommended that the procedure developed by the tax consultants to take account of specific adjustments to average deductions data as they are phased in under the Tax Reform Act of 1986 be applied until the new law is fully implemented. 1/

V. Further study

5.1 The review of the Joint Working Group focused on operational aspects of the average deduction system and on the need to take account of the effects of the 1986 Tax Reform Act on the average deductions currently used to calculate tax allowances and to net down comparator pay in the compensation exercise. There are, however, several issues that need to be carefully examined in light of the broader impact of the reform, and the need to phase in its implementation suggests that the system should be subject to continuing review. For example, the Working Group considered the question of extending the safeguard provision of the current system and concluded that such safeguard was clearly intended for staff employed prior to 1980 when the average deduction system became effective. The Working Group believes, however, that consideration may need to be given to some additional "safety net" when further informaton on the effects of the tax changes on the current system become available.

5.2 The longer-term effect of changes in average deductions under the new tax law may be very significant. Under the new law, the standard deduction is gradually increased and certain itemized deductions are eliminated immediately. Other itemized deductions are phased out, or must exceed a level set so high that the vast majority of taxpayers are precluded from claiming a deduction. The effects of the Tax Reform Act of 1986 on the operation of the average deduction system will continue to be evaluated as the new law is phased in.

1/ The Bank has already included these adjustments to the average deduction data used to make the three quarterly payments in 1987. The changes created by the 1986 reform were reviewed with the Bank Board Committee on Staff Compensation at the time of the 1987 salary review.

VI. Communications

6.1 The Working Group has recommended that improvements be made in communicating to staff the provisions of the tax allowance system. The Group has also recommended the development of an interactive computer program to provide staff with individualized tax allowance calculations based on their personal circumstances. The Personnel Vice Presidency is examining ways in which improvements in communication with staff can be implemented.

VII. Summary of Recommendations

7.1 It is proposed that the Executive Directors approve the recommendations with regard to the Tax Allowance system set forth in the paper as summarized below.

(a) The Bank apply from 1988, an average single deduction schedule in calculating tax allowances for single staff below the level of adjusted gross income where the proportion of taxpayers claiming a standard deduction has a significant impact on the average deduction data. The level of adjusted gross income would be reassessed periodically by the tax consultants.

(b) In the final year of employment, any safeguard payment made with respect to the previous years' tax allowance should be treated in the same way as other one-time payments. That is, it will not affect the level of income for the calculation of the deductions for that year.

(c) Adjustments proposed by the tax consultants for 1987 tax allowance calculations as well as future changes proposed by consultants to take account of specific adjustments to average deductions as they are phased in under the Tax Reform Act of 1986 be applied until the new law is fully implemented.

Attachments

EXCERPT FROM 1979 JOINT COMMITTEE REPORT
ON STAFF COMPENSATION ISSUES

ATTACHMENT I
(Excerpt)

6. TAX REIMBURSEMENT

Background

6.1 When the Bank and Fund were set up in 1946, the two Boards of Governors accepted that measures to eliminate or equalize the burden of taxation on Bank and Fund compensation were indispensable to achieve-ment of equity among members and equality among the personnel of the two institutions. Whilst it was recognized that elimination of the burden of taxation would achieve both these aims, it was accepted that all the necessary legal and other processes would take time and it was provided therefore that, in the meantime, equal treatment should be achieved by the reimbursement of taxes payable on organization income by those with a continuing liability to taxation. It was further agreed that organization income could be recognized for this purpose as a staff member's only income. It was a natural corollary of these measures that salaries should be set on a net-of-tax basis.

6.2 The constitutional and legal measures taken in furtherance of these aims are as follows:

6.2.1 The Articles of Agreement of the two bodies were so drafted as to preclude a Member Government from taxing compensation paid by the Bank or Fund to anyone who was not a national of the country concerned.

6.2.2 Under the Convention on Privileges and Immunities, most member countries waived their rights to tax the compensation paid by the Bank and Fund to their own nationals working in their own countries.

6.2.3 Virtually all Member Governments (except the United States) provide in their tax codes that income earned abroad by their nationals working abroad is not taxable.

6.3 The Governments of the United Kingdom, France, and the United States - amongst others - have, however, not acceded to the Convention on Privileges and Immunities; nor does the United States Government exempt from taxation the salaries earned abroad by Americans working abroad.

6.4 The Bank and Fund are, therefore, left with a system under which most of their staff are exempt from tax on their organizational income while the rest are reimbursed for taxes which they are still liable to pay. In precise terms what this means is that the only Bank and Fund staffs liable to pay tax on their organization income are United States nationals, whether employed in America or elsewhere, and the few French and United Kingdom nationals working for the Bank and Fund in Paris and London, respectively. All these account for just over one-quarter of the staff of the Bank and Fund.

6.5 The tax reimbursement system, which was adopted as a stop-gap in 1946, was intended to enable the same objectives to be achieved as total exemption would have achieved.

6.6 The main features of the tax reimbursement system adopted in 1946 were that, as has already been noted, no account was taken of outside income (except to a limited extent spouse income) and that, in assessing the amount of tax to be reimbursed, standard deductions were used.

Decision on Tax Allowance

Adopted by the Executive Directors January 16, 1980.

1. The Executive Directors after consideration of the proposals decided, in accordance with the terms of Section 14(b) of the By-Laws and the decision of the Executive Directors adopted May 25, 1979, that the principles and assumptions set forth below shall be used for the computation of tax allowances to be paid to United States nationals on the staff.

(a) The income received from the Bank shall be assumed to be the staff member's total income.

(b) The staff member will be assumed to file his income tax return in the most economical manner for his filing status.

(c) The computation of the tax allowance for each staff member will be made on the basis of (i) the staff member's marital status, (ii) the number of exemptions to which the staff member is entitled, (iii) the staff member's actual filing status, consistent with (b) above, except that where there is spouse income, the filing status will be determined in accordance with the method in effect before January 1, 1980, (iv) the amount of average deductions taken by a taxpayer with an equivalent level of income as shown by the most recent publication of the relevant statistics by the United States Internal Revenue Service for "All Returns" modified by the use of the computed tax allowance with respect to state income taxes for each staff member in place of the national average.

(d) During a five-year transitional period beginning with 1980, the computation of the tax allowance for each U.S. staff member appointed before January 1, 1980 shall be made both in accordance with (c) above and the method of computing the tax reimbursement in effect before January 1, 1980. The staff member shall receive in addition to the tax allowance computed under (c) above, a fraction of the amount by which the computation under the former system exceeds the tax allowance. The fraction shall be 5/6 for 1980 and shall be decreased by 1/6 for each subsequent year.

(e) Any U.S. staff member appointed before January 1, 1980 who considers the tax allowance received under (c) above, including any amount under (d) above, with respect to 1980 or any subsequent year to be less than the tax liability on his income received from the Bank for that year may claim an additional tax allowance. The

staff member making a claim for an additional tax allowance will be required to submit such documentation of income taxes actually paid for that year and such further documentation as is determined to be necessary to substantiate the claim and to make the necessary computations. The staff member will receive an additional tax allowance computed on the basis of the principles and assumption in (a), (b), and (c) above, except that the actual deductions claimed will be used but reduced by the proportion that the staff member's income from sources other than from the Bank bears to the total of the income reported on the staff member's return.

2. The principles and assumptions set forth above shall be applied to the extent practicable in the computation of tax allowances for those staff members who must pay income taxes to jurisdictions outside the United States on their salary and allowances received from the Bank.

3. The Management shall report to the Executive Directors with respect to each tax year of the five-year transitional period on the implementation of this tax allowance system.