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M. QURESHI'S
OPERATIONS CMTE

November, 1989 - February 1990

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February 23, 1990

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THE WORLD BANK
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee Meeting to Consider
JAMAICA - Second Trade and Financial Sector Adjustment Loan - I.M.

Held on Friday, February 23, 1990 in Room E-1243

A. Present

Committee		Others	
Messrs.	M.A. Qureshi (Chairman)	Messrs.	E. Grilli (EAS)
	S. Husain (LACVP)		A. Ray (EAS)
	R. Armstrong (AFRVP)		E. Segura (LACVP)
	O. Yenal (ASIVP)		J. Page (LA3TF)
	K. Dervis (EMNVP)		J. Sokol (LA3C2)
	V. Corbo (PPR)		H. Jones (LA3TF)
	D. Goldberg (LEGVP)		G. Flood (LA3C2)
	K. Kashiwaya (CFSVP)		H. Fazel (LA3C2
	D. C. Rao (FPRVP)		F. Earwaker (SPRPA)
			K. Siraj (CODOP)

B. Issues and Discussion

1. The OC met on February 23, 1989, to discuss the Initiating Memorandum for the proposed Trade and Financial Sector Adjustment Loan on the basis of an agenda prepared by the EAS. The Region indicated in its opening statement that this is expected to be the final loan to Jamaica in these areas, going as far as possible with tariff reductions given the constraints of the new CET and freeing interest rates except in the housing sector. It also reported that in its recent discussions in Jamaica, the Government has confirmed its intention to continue the policy reform program. It noted the progress being made in terms of recent food price increases, liberalization of agricultural trade, and divestment of publicly-owned hotels and some social services. The Chairman said that he would regard the GOJ's export promotion strategy as being critical in the medium-term program, noting the need for some exchange rate flexibility in that context. The Chairman also suggested that the macroeconomic indicators relevant to the second-tranche release be more explicitly stated. Several members also urged emphasis on the macro conditions, citing the recent OED report on adjustment lending in Jamaica.

2. On trade reform, the Region noted that while the recently adopted CET is not an appropriate long term tariff structure, there is much scope for clearing up various non-tariff interventions including stamp taxes, additional duties and quantitative restrictions, as a recently completed study of the CARICOM suggests. Our objective has been to make bilateral agreements with the important members to put pressure on the CARICOM to reform the CET. The recent improvements in the CET reflect Jamaica's

efforts, which in turn result from our earlier adjustment operations. The Chairman suggested that the wording of the CET-related conditions need to be clarified to indicate that we would expect the GOJ to adopt a tariff regime by 1991, that contains no non-tariff interventions and does not exceed levels under the recently negotiated CET. In this way even if the implementation of the recently negotiated CET is suspended, Jamaica still will go ahead with its tariff reform as agreed upon in this loan. On export incentives, the Region said that the current export subsidy will be eliminated under the new IMF stand-by, increasing the importance of introducing the duty drawback. A Committee member urged realism in this and other areas because he felt it would be important to avoid taking recourse again to waivers as in the TFSAL I.

3. Regarding the progress of reforms with the General Consumption Tax, the Region reported that the necessary legislation has been drafted and has to be passed as a pre-Board condition. Auditors are being trained with technical assistance from the IMF. In the case of the import monopoly of the JCTC, the Chairman suggested that restricting the reforms to such items as automobiles would not suffice; complete elimination of the monopoly should be sought.

4. The meeting endorsed the general thrust of financial sector reforms in the program, but some members questioned the rationale for retaining targetted interest rate subsidies for small farmers, particularly in light of the IDB's recent initiative in this area. The Region reported that it would be difficult to eliminate all credit subsidies to small farmers without giving them access to better services; for this reason the kind of changes being sought by the IDB would be unlikely to be accepted. The Chairman stated that nevertheless the Region should try to coordinate with the IDB in defining a common approach. The Region also clarified that the measures to be taken to strengthen the supervisory capacity of the BOJ would adequately meet the concern expressed in the agenda regarding financial reporting. A Committee member stressed the importance of developing the secondary capital market. The Region noted that although the proposed conditions did not seem to deal with the topic directly, improvements in the securities and equities markets under the loan would provide initial impetus to capital market development.

Decisions

5. The Chairman agreed that the Initiating Memorandum provided an adequate basis for appraisal. However, he urged the Region to develop the second-tranche conditionalities in objective terms and to focus on the "core" group of conditions. He felt that there were a number of conditions in the present matrix which were either not clear or not sufficiently important to be included in the legal documents (although they should remain as a part of the program).

ARay:vl
February 27, 1990

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

900221024

MHQ 1.

Export Promotion Policy

1. Anything more feasible for exports than duty drawback before the second tranche

2. Can we do more for [illegible] growth of non trad exports

Export processing zone

Fiscal has approved [illegible] regime

DATE: February 21, 1990

TO: Operations Committee

FROM: Enzo Grilli, Acting Director, EAS

EXTENSION: 78061/2

SUBJECT: JAMAICA: Second Trade & Financial Sector Adjustment Loan: Initiating Memorandum (IM) - Agenda

1. The Operations Committee will meet on Friday, February 23, 1990 at 4.30 p.m. in Room E-1243 to discuss the IM on a proposed second Trade and Financial Sector Adjustment Loan (TFSAL II) to Jamaica in the amount of $25 million.

Introduction

2. The first Trade and Financial Sector Adjustment Loan (TFSAL I) to Jamaica in the amount of $40 million was approved by the Board on June 17, 1987, and was fully disbursed by March 28, 1988. Under TFSAL I, import tariffs were reduced and their dispersion narrowed, import licence requirements on some 100 items were removed and a Tariff Reform Commission and an Anti-dumping Committee were established. As a part of that TFSAL, the GOJ formally notified the Caribbean Community and Common Market (CARICOM) of its intention to negotiate a revised common external tariff (CET) with a band of 5% to 30%. However, at the request of GOJ, some of the second tranche conditions of the loan were waived. First, a condition requiring the introduction of a 5% minimum tariff on some agricultural inputs and printed material was waived. This will now be a condition for Board presentation of this loan. Second, a proposed measure to reimburse exporters for import duties and indirect taxes was also waived. This will be a condition of the second tranche of this loan. Finally, a condition to announce the next phase of the reform by the Tariff Reform Committee was waived. This would be now met before Board presentation. The financial sector component of the TFSAL I included the reduction in forced loans to the Government by the commercial banks, improvements in the tax structure to reduce a bias against equity investments, and the strengthening of Bank of Jamaica's monetary management and supervisory capability.

3. The TFSAL II supports the reform process initiated in 1987. On the trade side, it would support measures to reduce tariffs to the new common external tariff level (which is however higher than the target tariff rates planned in TFSAL I), eliminate the remaining tariff exemptions and reference prices, eliminate an important state import monopoly for various imports (JCTC), reform the indirect tax system and strengthen custom and anti-dumping procedures. In the financial sector, the TFSAL II will support measures to reduce credit subsidies, eliminate limits on consumer credit, strengthen the securities markets and the instruments for controlling monetary and credit policy, improve supervision and prudential regulations, and correct disparities in the incidence of controls on the commercial and merchant banks.

4. The TFSAL II is intended to support the trade and financial policy reforms within an acceptable macroeconomic policy framework. The standby that was approved in September 1988 and was later modified (following the damage caused to the economy by hurricane Gilbert) has been breached. A new IMF standby program, recently negotiated, is a condition of Board presentation for this loan.

Development Strategy and Macroeconomic Policies

5. The IM reports that although the GOJ has been negotiating short-term macro-economic concerns with the IMF, it is yet to formulate a coherent medium-term program of structural adjustment. Would the Region provide an update of where matters stand with respect to the medium-term strategy and the role of this and forthcoming adjustment loans in that context?

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6. It is also reported that the IMF has agreed to a devaluation of the exchange rate which will now be linked to a net external reserve target. The OC had on earlier occasions expressed concern about the rigidity of the exchange rate regime in Jamaica, particularly in view of the pressure it puts on the Government to reduce aggregate demand and employment in order to defend fixed exchange rates. Would the Region explain its intentions regarding the proposed macro-economic conditionality in the loan? What would be the key macroeconomics indicators influencing the decision on the second tranche release?

Which Macro-Economic Indicators would be used

Trade Reforms

7. The several changes proposed in the areas of trade and domestic taxes will form the most significant part of the loan. The main issues are:

CET higher than Jamaican objectives

Feasible to make new CET condition of 2nd tranche

- The Region may wish to comment on the CET of CARICOM which at 45% is higher than the level that was to have been achieved under TFSAL I (in the 5% to 30% range by 1991.) What policy choices does Jamaica have in reforming its trade regime and yet conform to the CET? Can we make the introduction of a new CET in a form acceptable to the Bank a condition of the second tranche release (see Matrix, page 1)? Similarly, is it appropriate to propose a pre-Board condition that GOJ will notify all CARICOM governments of its intention to seek further revisions of CET, given that CET negotiations were only recently concluded?

Who is proposing the change

- The idea of compensating exporters for import duties and taxes has been considered for sometime; in fact it was a condition of TFSAL I as mentioned earlier. Would the Region explain what the issues are - are there political difficulties that can once again cause problems at the second tranche stage or are the problems purely logistical? Would the Region also report on the existing policies (for example, export processing zones) on promoting non-traditional exports, and whether there is a case for enhancing them through this loan?

Reasons for not going ahead with exporters compensation scheme

- The elimination of the import monopoly of JCTC, the reforms of customs procedures, and the introduction of the General Consumption Tax have long been very difficult issues. The Region may comment on their feasibility, explain the importance we should attach to them, and indicate possible fall-back positions.

When is this to ? Is this a tranche release condition ?

Financial Sector Reforms

8. The Region may wish to elaborate upon the overall objectives of the financial reforms, with emphasis on the "core" conditions.

- Is the proposed interest rate policy reforms consistent with the approaches of the IMF and the IDB? Should we agree to a continuation of small-farmer credit subsidies, or should we explore the alternative of abolishing the subsidies while "compensating" the farmers through commodity-specific subsidies during a transition period?

Raise it the treasury bill rate

Nature of subsidies Commodity specific subsidies

- The IM suggests that the current solvency and creditworthiness position of the financial institutions is unknown since the quality of the BOJ audit is uncertain. The Committee may wish to ask the Region whether it would not be advisable to include in the proposed operation a specific conditionality to ascertain the true financial condition of the financial institutions in order to take steps to restore their solvency and creditworthiness.

- A revision of the BOJ Act is necessary to strengthen the legal framework for bank supervision. The matrix attached to the IM (Page 8) requires, as a condition of the second tranche release, "satisfactory progress in submitting the legislation." The Committee may like to discuss if this is a satisfactory enough condition or should we require more concrete progress such as approval of the Act or implementation of the Act.

What does this mean

Specificity of Second-Tranche Conditions

9. Many of the second-tranche conditions are currently formulated in an open-ended manner, relying on "satisfactory" progress as the benchmark. The Committee might consider whether we should try to develop objective indicators, at least for the core conditions.

Operations Committee

Messrs. M.A. Qureshi, S. Husain, E. Jaycox, A. Karaosmanoglu, W. Wapenhans, V. Rajagopalan/S. Fischer, I. Shihata, K. Kashiwaya, D.J. Wood, H. Vergin

cc: Messrs. D. Lee, A. Shakow, J. Holsen, D.C. Rao, D. Bock, R. Picciotto, S. Burmester/T. Thahane, D. Goldberg, Ms. N. Okonjo-Iweala, W. Thalwitz, J. Parmar, J. Linn, B. Kavalsky, G. Pfeffermann, R. Liebenthal, F. Kilby, C.L. Robless, Ms. M. Haug, A. Khanna, M. Selowsky, E. Segura, G. Flood, Sokol, Page, Jones.

SRajapatirana/ARay:gs:vl

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

900214004

1.

OFFICE MEMORANDUM

DATE: February 12, 1990

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

FROM: S. Shahid Husain, Regional Vice President, LACVP

EXTENSION: 39001

SUBJECT: JAMAICA - Proposed Second Trade and Financial Sector Adjustment Loan Initiating Memorandum

1. Please see attached, for the Operations Policy Committee's consideration, an Initiating Memorandum for a proposed Second Trade and Financial Sector Adjustment Loan to Jamaica.

2. The proposed loan is in accordance with the CSP recommendations made in July 1989 and forms an integral part of the Medium Term Economic Framework Program (MTFP), and related financing plan, to be discussed with the Government this month. The proposed loan would be in the amount of US$25 million and would be cofinanced by Japan OECF in an equal amount. The IDB has recently indicated that it is also interested in cofinancing the proposed loan in the amount of US$25 million equivalent.

3. The proposed project would support the Government's trade and financial sector reform program which was begun in 1987 and which was supported by the first Trade and Financial Sector Adjustment Loan (2848-JM). It would support the ultimate phases of Jamaica's trade reform program and complete the trade liberalization which can be accomplished within the revised Caribbean Community and Common Market (CARICOM) Common External Tariff (CET). While the proposed trade reforms fall short of the objectives of Jamaica's trade policy reform announced in 1987 (to establish duties in the 5% to 30% range by 1991), it will eliminate all protective devices other than tariffs, make the protective system transparent, and reduce the range of duties and levels of protection. The revised CET is to be introduced in January, 1991 with a schedule of duty rates between 0% and 45%. Further tariff reform would require reductions in the revised CET. A condition of the proposed loan would be that Jamaica formally notify the CARICOM governments of its intention to negotiate further revisions of the CET to reduce the range of tariffs to the original targets of the Jamaica trade reform when the reform was initiated in 1987. The program to be supported by the proposed loan also includes measures to strengthen the customs department and anti-dumping procedures and reform the system of indirect taxes.

4. The financial reform measures would build on those taken under the first Trade and Financial Sector Adjustment loan and would include steps to: (i) eliminate credit subsidies in the industrial and agricultural sectors (except for credit subsidies to small farmers which would be reduced) and those provided through credit unions, reduce others, and establish a system of accounting in the development banking system which would make credit subsidies transparent in order that those that remain could be reduced to an affordable level; (ii) correct disparities between commercial banks and merchant banks; (iii) strengthen the regulatory framework for financial institutions; and (iv) strengthen the secondary market for government securities in order that more effective open market

operations can be carried out and monetary policy can be implemented more efficiently. When these major steps and others included in the program are implemented, the main distortions in credit markets would be eliminated, the regulatory framework would be sound and the basis for developing a broader capital market would be established. The only significant credit subsidies which would remain would be for housing finance, resources for which are provided by payroll and employer taxes. This issue is being addressed under a proposed Housing Project which is under preparation.

5. As you know, the Managing Director of the IMF has just approved the GOJ letter of intent for an IMF Stand-by for 1990/91. Among other things it was agreed that the exchange rate would be changed from J$6.5 to J$7 per US dollar. This rate will be fixed and linked to a net international reserves (NIR) target. The agreement to link further exchange rate action to a NIR target will assure that further adjustments will be made to maintain a competitive exchange rate as the trade liberalization proceeds. It is essential that the trade and financial sector reform programs be carried out within an acceptable macroeconomic framework. We would therefore include a condition of second tranche release in the loan agreement that satisfactory macroeconomic policies (i.e. exchange rate, fiscal and monetary policies) would be maintained during the implementation of the proposed loan. A commitment on this matter would be spelled out in the letter of development policy which we would require from the Government prior to approving the proposed loan.

6. The proposed project would support efforts to complete (except in those areas mentioned above) the Government's programs of trade and financial sector reform. The trade reform would reduce protection and make it more uniform across sectors and subsectors and increase competition and the efficiency of enterprises. The fiscal impact of the trade reform is expected to be relatively small as duty reductions for some goods is expected to be offset by increases in duties on others and by the elimination of duty exemptions for a range of products. Moreover, any projected reductions in such revenues is to be taken into account in establishing the rates for the General Consumption Tax to be introduced in April 1990. The financial sector reforms would strengthen the means for managing monetary policy, improve the regulation of financial institutions and make the allocation of financial resources more efficient. The project would support the Government's stabilization program and help close Jamaica's financing gap.

JHones:mr

cc: Messrs./Mesdames. Jaycox, AFRVP; Karaosmanoglu, ASIVP; Lari, EMNVP; Wood, FPRVP; Shihata, Scott, LEGVP; Rajagopalan, PREVP; Fischer, DECVP; Vergin, Robless, Baudon, OPNSV; Dubey, Thumm, EASDR; Lee, CODDR; Kashiwaya, CFSVP; Bock, Flannery, CFSDR; Thalwitz, PPRSV; Shakow, SPRDR; Holsen, CECDR (3); Linn, IECDR; Churchill, IENDR; Barry, IENIN; Molares, Collell, LEGLA; Stern, FINSV; Rao, FRSDR (2); Barahona, LOAEL; Frank, CFPVP; Parmar, CIOVP; Decarli, Schmitz, IMF; El-Rifai, MIGPA; Segura, Selowsky, Linder, Quijano, LACVP; Wessels, LATDR; Iskander, LATTF; Loh, Garcia-Zamor, LA3DR; Page, LA3TF; Sokol, Fazel, LA3C2; Jones, LA3TF; Goswani, Ramachandra, LATTF; Dado, CECTP; Little, Consultant; Regional Information Center.

February 16, 1990

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THE WORLD BANK
Operations Committee

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Minutes of the Operations Committee to consider
PAKISTAN - Transport Sector Adjustment
Loan: Initiating Memorandum
Held on Friday, February 16, 1990 in Room E-1243

A. Present

Committee	Others
Messrs. M. A. Qureshi, Chairman	Messrs. Y. Abe, EM1IN
S. Husain, LACVP	A. Abu-Akeel, LEGEM
E. Jaycox, AFRVP	P. Crevier, SECGE
D. Goldberg, LEGOP	Ms. M. de Nevers, FRSCR
R. Cheetham, ASIVP	V. Dubey, EASDR
K. Kashiwaya, CFSVP	S. El Serafy, EAS
L. Pouliquen, PREVP	A. El Maaroufi, EMNVP
D. C. Rao, FPRVP	P. Hasan, EMNVP
K. Dervis, EMNVP	I. Elwan, CFSPS
	K. Krishna, EM1DR
	J. Lane, EMTIN
	Mrs. N. Okonjo-Iweala, OPNSV
	P. Rashid, CODOP
	G. Reif, SPRPA
	J. Tillman, EM1IN
	Ms. L. Yap, EM1CO

B. Issues

1. The Operations Committee met on Friday, February 16, 1990 to consider an Initiating Memorandum for a proposed Transport Sector Adjustment Loan to Pakistan in the amount of $230 million, including $130 million for investments and technical assistance. The Committee followed the Agenda prepared by EAS which raised, among others, the issues of the "hybrid" format proposed for the loan; leaving out ports and aviation from sectoral adjustment; institutional capability for administering the program; past Bank experience with the railways; the earmarking of road user charges for the highways; and Pakistan's creditworthiness for the proposed IBRD lending.

C. Discussion

2. The Chairman invited the Region to make an introductory statement, addressing, in particular, the justification for a hybrid operation. The Region said that the operation was quite a comprehensive one, aiming at reforming the sector and integrating it in the growth of Pakistan's

economy, with emphasis on a core investment program. Reforming the sector would improve macro management and contribute to balancing the budget and the balance of payments. The operation fitted into the context of the December 1989 PFP, and its quick-disbursing component would meet part of a shortfall in foreign exchange resulting from recent terms of trade deterioration.

3. The Chairman, while noting the good program proposed for the highways and railways, said that he did not see how this integrated with the quick-disbursing component being proposed which should relate to sector objectives. It was not enough just to say that deterioration of the terms of trade made additional funds necessary. This approach puts the whole hybrid mode into question. Terms of trade deterioration can best be addressed by the IMF through compensatory financing. He further observed that the total investments to be financed are $170 million of which the Bank would finance $130 million. He did not see that topping this up by another $100 million would be justified. Raising the lending program to over $1 billion in FY90 did not serve a useful purpose if lending has to be sharply reduced in FY91 in order to remain within the three-year lending allocation.

4. A member said that he found it strange that terms of trade deterioration is to be redressed by Pakistan borrowing on IBRD terms. Large undisbursed aid on soft terms remained, which should be used before resort is made to the harder terms IBRD funds. The proper response before it came even to that, was to press for domestic resource mobilization. He observed that financial management had recently deteriorated in Pakistan, and that making quick-disbursing funds available at this stage would give the wrong signals. The Region responded that the OC had, two years previously, approved annual lending of $300 million in quick-disbursing funds, and that Pakistan had adjusted the exchange rate and taken other measures to encourage exports. While it was true, the Region added, that softer term aid was available, such aid tended to be inefficient, and government strategy has been to seek more efficient aid through borrowing from the IBRD, the ADB and the Japanese. The same member retorted that domestic investment in Pakistan had become totally reliant on external financing; in fact external financing had tended to exceed investment, to the deterioration of efforts at mobilizing internal resources.

5. Another member questioned whether Pakistan qualified for the high case lending of $800 million a year as set out in the CSP, and whether in fact a lower case was not more relevant. When the Chairman observed that there was no question that Pakistan qualified for the high-case lending, the same member said that in determining our exposure we should also take account of the Expanded Cofinancing Operation (ECO) that was now being processed, and the Chairman added that he attached high priority to the ECO in view of the leveraging of resources it can bring about.

6. The Chairman returned to the hybrid issue. Unless there was some good sectoral justification, he thought that the sector investment operation format was more appropriate. He concurred with a Committee member's earlier statement that mere terms of trade deterioration did not automatically justify quick-disbursing lending. Additional measures to mobilize domestic resources were called for as well as seeking assistance

from the IMF; that is why he was reluctant to raise the lending program this year. The Region responded that no other quick-disbursing lending was being contemplated this year, and if a quarter of lending were to be in that form, it was reasonable to lend $200 million in quick-disbursing funds if we were lending $800 million for investment. Moreover, this loan appeared to be the most suitable vehicle for a quick-disbursing component since some of its provisions were closely related to macroeconomic objectives. To this the Chairman said that in that case there should be good justification in order to establish a closer linkage between the investment and adjustment components. He had reluctantly approved an approach such as the one proposed in one or two cases in poorer and smaller countries in urgent need of funds, but Pakistan's balance of payments would not be disrupted if this quick-disbursing component were eliminated. To the Region's point that quick-disbursing funds could finance a positive list of identifiable imports for the sector, the Chairman said that such a list could easily be accommodated by normal lending, but if budgetary support was required for the sectoral program, a case had to be clearly made for it.

7. When the Region said that the macroeconomic justification for quick-disbursing funds was to be found in the PFP, the Chairman reiterated that he did not want to use the proposed instrument just to add money to our lending since this would give the wrong impression on both sides. We had, he said, agreed on a program in July in cooperation with the IMF; if now we find a larger resource gap, additional steps have to be worked out, also with IMF cooperation. The Region responded that even before July a financing gap had been anticipated, and that quick-disbursing lending was the vehicle expected to be used. A member thought, however, that the PFP/CSP framework was too broad to be used for justifying quick disbursement for any one operation. For that purpose we wanted to consider government response to terms of trade deterioration. Another member added that, apart from the PFP, there was no additional conditionality proposed for the quick-disbursing component, and there was no SAL in place either. In his Region, he added, although the PFP triggered a SAF operation by the Fund, it did not amount to an entitlement by the borrower for quick-disbursing funds. The threshold provided by the PFP had never been high enough to commit IDA funds; and later on the ESAF came along. Pakistan's would, to his knowledge, be the first case we would commit funds on the basis of a PFP without additional conditionality. The Chairman concurred with this view, adding that his concern goes beyond this particular issue.

8. Focusing on the specifics of the sector, the Chairman asked why did we not have in the IM a more comprehensive view of Pakistan's transport sector. The Region said that they intended to process a ports operation in FY1991, with emphasis on better port capacity utilization. This had originally been conceived as part of the present loan, but was processed earlier because of pressing needs in the ports. Negotiations had, however, been delayed for other reasons. Also the aviation subsector was originally intended to be covered, largely through initiation of studies, but was later excluded in order to simplify this operation. The Chairman asked for the linkage between this operation and the other subsectors to be treated in greater detail in the President's Report.

9. A member acknowledged the fact that the modes focused upon (railways and highways) were critical to the transport sector. However he observed that besides the federal road network there was a provincial one which was perhaps ten times greater, and this should have been covered in the interest of a comprehensive transport policy. As to the ports, there was concern over excessive investing, although investment in the sector as a whole appeared to be highly desirable. Such a broad picture should also cover domestic aviation and its subsidization. Why confine involvement to two subsectors in which we delve deeply, leaving aside provincial roads and other subsectors? To this the Region replied that the federal highway system provided the key to the Pakistani economy, and that working on the provincial system in the Bank has only recently been started. Moreover, ADB was actively involved in supporting the provincial road program. Failing a full coverage of the sector, the Region opted to be selective. The Bank's proposed support for ports was intended to promote rationalization, and address key constraints such as loading/unloading, and poor trade logistics. The Region's main concern was to promote investment both in Karachi and Qasim ports in an optimal manner. Whether aviation enjoyed major subsidization, or just cross subsidization from other modes, was still an issue, and aviation was left out as the involvement of the military would raise sensitive issues which are difficult to address, and might therefore act as a drag on project processing. The Region added that paragraph 28 of the IM defined a core investment and maintenance program across the whole sector.

10. The Chairman then took up the issue of sector coordination, and whether the sector's institutions were up to performing such a task. In response the Region said that each operating agency was doing its job within its own subsector. The aim was to see in place a ministerial structure that would enhance coordination among the various modes. The Chairman remarked that we have been involved in the Pakistan transport sector since 1962, with eight operations up to 1985: to what extent do we know that we shall be more successful this time than before? The Region responded that the program was now being proposed jointly with the Pakistani authorities, which are impressed by losses incurred by the Railways. It was a good sign that an economic committee of the Cabinet has been discussing various changes with the Bank. The National Highway Board was instrumental in introducing a new system of priority ranking of roads for rehabilitation/maintenance and was implementing the ongoing Fourth Highway project efficiently. The Railways was already implementing an operational improvement plan on the basis of a program designed with Bank assistance. There appeared to be a strong commitment on the part of the Railways to improve its image and deliver a higher quality service. A paper on the railways had been prepared and would have to be approved by the Government before March. This kind of urgency had been absent before.

11. A member remarked that responsibility for the sector remained divided, and that he saw no signs of better cooperation. Concurring with this the Region said that the Railways in particular was seeking cooperation, and that it was clear that the various modes were being increasingly seen as complementing each other.

12. The Chairman then turned to the issue of "user charges," and asked whether these were earmarked for the sector, and whether there was a gap

between their proceeds and sector requirements. The Region said that such charges were not earmarked for sector use. Should they be earmarked? The Chairman asked, and the response was that we should avoid this issue at this stage. The Region added that all fuel prices were now equal to border prices; and that ensuring adequate maintenance funds should be a priority issue and that extra funds were being allocated for that purpose.

13. A member mentioned the availability of counterpart funds and another the absence of a mechanism for timely allocation of resources for the sector, including payments due to contractors, and the Chairman urged the Region to cover this. The Region stressed that they have been working on a maintenance strategy identifying priorities so that, should funds become scarce, the maintenance program would not be disrupted. Another member wanted clarification about the possible privatization of the railways and the Region said the survival of the railways was at stake, and that government attitude to railway privatization was unclear. Well before we come to that, putting the railways on a corporate footing was a priority, so that it could balance its financing in a commercial way. Privatization was improbable at least for the next five years. But part of railways operations, such as container terminal facilities and services, could indeed be privatized and some of the manufacturing establishments now under the Railways could also be privatized. Many banks in the US, for example, had equity in American Railways.

D. Decision

14. In conclusion the Chairman said that the $200 million seemed an adequate size for this operation rather than the proposed $230 million and that the loan should be a sector investment loan. He stated that the Region might consider including a component for spare parts which would disburse quickly. Combining an investment component with an adjustment component that would disburse quickly, as was now being proposed, was possible, but the quick-disbursing component should be designed in the context of specific conditionality and be integrated with sectoral policy and the macroeconomy. While this was not the case at present, he was prepared to consider such a component in which case he expected a memorandum from the Region justifying such a design, to be circulated to the Operations Committee on a no-objection basis.

February 26, 1990
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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

90024005 1.

OFFICE MEMORANDUM

DATE: February 14, 1990

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXTENSION: 78051

SUBJECT: PAKISTAN: Initiating Memorandum for a Transport Sector Adjustment Loan
A proposed Agenda

1. The Operations Committee will meet on Friday, February 16 at 3.30 p.m. in Room E-1243 to discuss the Initiating Memorandum (IM) for a Transport Sector Adjustment Loan in the amount of $230 million, made up of $100 million in quick-disbursing funds and $130 million to support investments (and technical assistance) which make up part of Pakistan's core investment and maintenance program (CIMP) in the transport sector for FYs 91-93, the last three years of the Seventh Plan.

Background and Loan Objectives

2. This operation aims at reforming the Railways and the Highway subsectors through institutional, financial and managerial restructuring, with studies and actions to be initiated to improve the sector's coordination and planning, bulk handling, storage and transport policies and facilities. One aim of the loan is to provide financial support for crucial investments in the CIMP in view of the fact that implementation of the Plan has been lagging. The rationale for the quick-disbursing adjustment component lies in recent terms of trade deterioration which has raised balance of payments requirements by $500 million a year. A second year PFP, approved in December 1989, provides a comprehensive framework for the macroeconomy for the transport sector. The envisaged reduction of railway losses, and the revenue to be raised from road users would contribute to the macroeconomic balance. The overall savings expected in transport costs would reduce the domestic costs of imports and exports and improve international competitiveness. The most important sectoral objectives of this operation are (a) improving highway efficiency and planning, construction, and maintenance; (b) restructuring the Railways to enhance its ability to compete with the highways; (c) developing the trucking industry; and (d) adjusting taxes and road user charges.

The Hybrid Format and Cross Conditionality

3. The quick-disbursing part of this loan ($100 million) is expected to disburse over two equal tranches in July 1990 and December 1991, respectively, but the loan would not close until the end of 1995: four and a half years after second tranche release. No cross conditionality is proposed between the two loan components except that if the second tranche conditions related to the railways were not met, no new contracts would be signed. Three Railway second tranche conditions are envisaged: (a) "Public Sector obligations losses" would be charged to the Government's account (for such things as employment,

uneconomic lines, freight tariffs for strategic items); (b) an action plan for closure of uneconomic services and for cost reduction would be initiated by June 1991; and (c) tariffs to be raised to make the commercial services financially viable by June 1990, with a formula proposed so that "continued progress" is achieved by the second tranche.

- o In view of the long time horizon of the investment program, the Committee may wish to question the design proposed, and whether the hybrid instrument is the appropriate one in this respect.

- o If the Committee agrees that the cross conditionality envisaged is appropriate, why confine it to the railways to the exclusion of the highway subsector?

- o Are the "public sector obligations" (para. 50) determinate? And, supposing they are, can their costs be objectively estimated?

- o Is the Government willing to accept such a condition and able to meet its financial implications?

- o The Region might also clarify the condition that tariffs would be raised "on the commercial services" to make them financially viable. Is not the aim to make all services financially viable?

The Transport Sector as a Whole

4. The IM gives a good description of the mal-functioning of the various modes of transport, identifying some of their problems. The situation in the Ports looks quite serious (see paras. 14 and 15 of the IM) and yet they, and aviation, have been left out from sector reforms. Since good sector development should involve proper interfacing of all the various modes:

- o Why are the Ports and Aviation modes left out of what should be an integrated sectoral reform approach?

- o How does the Karachi Port project, foreshadowed for FY91, relate to this operation?

Sector Coordination

5. The IM draws attention to the lack of a Federal Secretariat with an overview of the sector as a whole. A Coordinating Committee under the Planning Commission is to be set up by loan effectivenes and, six months prior to second tranche release, would examine sector coordination. By tranche release the Government would agree with the Bank on an action plan and implementation schedule.

- o Is such a body likely to accept the changes in the railways and highways systems this loan will have brought about?

- o Until such a body is set up, are the existing institutions capable of implementing the ambitious program envisaged?

The $130 million Investment Component

6. The loan is said to assist the financing of "the minimum transport investment and maintenance program critical for the success of the transport development strategy" during the last three years (FYs 91-93) of the Seventh Plan. Fifty million would finance investments in the highway subsector and $80 million in the railway subsector, with small components for technical assistance.

- The Region might give a short account of transport sector implementation under the Seventh Plan from its inception, and clarify the sense in which the proposed investments are minimal and critical for the program, particularly as the items to be financed under the railway CIMP are yet to be identified (para. 46).

The Railways

7. The IM presents a good description of the state of affairs prevailing in Pakistan railways, with the railways performing functions for the Government for which it does not get paid. Rail traffic has become concentrated on a few long distance routes. Freight traffic, particularly general cargo, is being lost to the highways, and the railways workshop capacity exceeds its requirements. Besides agreeing during appraisal with Pakistan Railways on operational improvements the loan aims at converting Pakistan Railways into a public corporation after rationalization of facilities and finance. Financial measures envisaged include (a) Government compensation of PR for surplus staff; (b) reducing socially-oriented services; and (c) tariff increases to make PR services financially viable. At negotiations a corporate plan would be agreed to cover these reforms and others involving management.

- What has been the record of Bank involvement with the Railways subsector?

- Should the Bank get involved in such details as the number of managers reporting to the General Manager to be incorporated in a dated covenant (Annex 1, page 7)?

The Highway Component

8. The sector is largely in private hands and has been growing rapidly with a major role being played by a modern trucking business. Plans are in hand to develop an action plan to improve availability of parts, warehousing and terminals, and truck safety standards. At negotiations an agenda of reforms will have to be agreed, to be implemented beginning June 1991 (i.e. six months ahead of tranche release). The National Highways Board, so far without permanent staff and with limited effectiveness, is to be developed for planning and managing the highway system. The structure and functions of this institution are yet to be determined at negotiations, and an action plan will be put into effect by June 30, 1991, again ahead of the second tranche. For resource mobilization, raising fuel prices to international levels would be a condition of effectiveness, and continuation of this policy a condition of the second tranche release.

?

Further resource mobilization efforts are under consideration (including tolls) and will be discussed by the appraisal mission. Maintenance of roads has seriously lagged, and sections of major carriageways have become "unmaintainable." An investment component under this loan will finance a "Maintenance Backlog Reduction Program" which the Government will be asked to finance and future maintenance priorities would be agreed with the Bank.

- o <u>In the absence of an adequate institutional set-up, the Committee might consider if this program is too complex to be squeezed into the short time available</u>.

- o <u>Are the so-called road user charge proceeds already earmarked for use by the subsector?</u>

- o <u>Is the state of highways compatible with the heavy demands put upon it by the trucking industry?</u> <u>And, should not a temporary plan be devised to make use of the underutilized railways until the conditions of the roads improve?</u>

Creditworthiness

9. The present operation, originally planned at $200 million, raises total Bank lending to Pakistan in FY90 to over $1 billion, most of which on IBRD terms. ?

- o <u>In view of the fact that prudent creditworthiness limits have been stretched for Pakistan for some time, the Committee might discuss the implications of this operation for creditworthiness</u>.

Environmental Aspects

10. The operation contains a paragraph on environmental aspects (para. 42) saying that programs would be developed by the end of next year to reduce pollution and improve safety of transport of hazardous cargoes, to be translated into an action plan for implementation after June 1992.

- o <u>Would the Region sketch what is envisaged in this respect, and whether the cost of pollution reduction would be economically justified in the present conditions of Pakistan</u>.

Procurement

11. The IM proposes (para. 50) that the investment component of the loan would finance 100% of foreign expenditures, 70% of expenditures for civil works under the "Maintenance Backlog Reduction Program" and 100% of expenditures for consultants' services. The retroactive financing proposed ($13 million) seems reasonable in size as well as justifiable.

- o <u>The Committee might discuss if these arrangements are acceptable; and whether the conditionality should clearly enable financing local consultant services</u>.

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Distribution:

Messrs. Qureshi, OPNSV; Husain, LACVP; Jaycox, AFRVP; Karaosmanoglu, ASIVP; Wapenhans, EMNVP; Rajagopalan/Fischer, PPR; Shihata, LEGVP; Kashiwaya, CFSVP; Wood, FPRVP; Vergin, OPNSV.

cc: Messrs. Lee, COD; Shakow, SPR; Holsen, CEC; Rao, FRS; Bock, CFS; Picciotto, PBD; Burmester/Thahane, SECGE; Goldberg, LEGOP; Ms. Okonjo-Iweala, OPNSV; Kassum, CS2; El Serafy, EAS; Thalwitz, PPRSV; Parmar, IFC-CIO; Linn, IEC; Kavalsky, FRM; Pfeffermann, IFC-CEI; Liebenthal, SPRPA; Kilby, FRS; Robless, OPNSV; Ms. Haug, EXC; Khanna, EXC; Hasan, EMNVP; El Maaroufi, EMNVP; Kopp, EM1DR; Penalver-Quesada, EM1CO; Abe, EM1IN.

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 9, 1990

TO: Mr. Moeen A. Qureshi

FROM: W. A. Wapenhans, EMNVP

EXT: 32676

SUBJECT: PAKISTAN - Initiating Memorandum for Transport Sector Adjustment Loan Operations Committee Review

Measures to use the sector program to be [illegible]
Program is 175 million
need [illegible]
Com [illegible]

1. Attached is the Initiating Memorandum for the proposed Transport Sector Adjustment Loan for US$230 million, for review by the Operations Committee.

Make [illegible] indicators

2. The proposed loan is a hybrid with a package of policies aimed at sectoral reforms and with investment components included in the core investment and maintenance program for FY91-FY93 which are critical to achieving the Seventh Plan objectives. The proceeds of the quick disbursing part of the loan (US$100 million) would be made available in two tranches, the first following compliance with conditions of effectiveness expected in July 31, 1990 and the second following compliance with conditions for the release of the second tranche, expected in December 31, 1991. The proceeds of the investment part of the loan (US$130 million) would be disbursed according to specific disbursement conditions for those components.

3. The proposed loan builds on broad agreements we have reached with the Government and Operating Agencies on transport sector reforms, during an extensive period of discussions to assist the development of coherent and achievable sector adjustment policies and programs. A consensus has evolved on the need for fundamental changes in the role of the railway and for improved highway management and maintenance; initial actions by the Railways and National Highway Board have begun to show impressive results. Government commitment to major changes is evidenced (i) by the preparation, at Cabinet request, of a railway reform paper and (ii) by allocation of highway maintenance funds based on the newly developed maintenance intervention program. With these commitments, we propose to send an appraisal mission in mid-February 1990.

4. The basis for a quick disbursing loan to Pakistan is the Policy Framework Paper (PFP) for the period 1988/89-1990/91 which outlines the government's framework of medium-term macro-economic policies and structural adjustment measures. The Board reviewed the second year PFP in December 1989. The proposed loan is not only consistent with the structural adjustment measures outlines in the PFP, but would both assist with implementing the transport measures included in the PFP and assist the Government to give priority to the core of investment and maintenance programs needed to ensure adequate growth in transport capacity to meet future economic needs. The latter consideration led to the proposed loan being formulated as a hybrid loan. The key adjustment measures to be supported by the loan are:

(i) Institutional, financial and managerial restructuring of the Railway to permit development of its commercial potential; and

(ii) Institutional and financial strengthening of the National Highway Board, together with adoption of investment and budgetary criteria to redress the imbalance between expenditures on new carriageways, rehabilitation and maintenance.

Also during the course of the loan (a) the recently prepared agenda for trade facilitation would be implemented; (b) an agenda for the trucking industry agreed and implementation begun; (c) studies undertaken on bulk handling, storage and transport policies and facilities; (d) a program developed for improving the transport of hazardous cargoes and reducing automotive pollution; and (e) studies to improve sector coordination and planning.

5. As we indicated in the last Country Strategy Paper, there is a country need for balance of payments support as part of the adjustment program. The need is even greater now than when the CSP was approved because of the unexpected deterioration of the terms of trade in FY89 and its expected continued weakness throughout the rest of the program period (to FY92). For instance, as of December 1989, projected gross external financing requirements for FY90 and FY91 were \$3.3 billion and \$2.9 billion respectively as compared with projections of \$2.7 billion and \$2.5 billion made at the time of the first year PFP in December 1988. One of the objectives of the adjustment program is to reduce the current account deficit to a level (2.6% of GNP) which can be sustained over the long-term. During the adjustment period, it is important that external financing requirements be met primarily from sources like the World Bank in order to strengthen creditworthiness and reduce the debt service ratio over the long-term. The TSAL, it should be noted, is the only SECAL for Pakistan being presented to the Board in FY90; we are planning only one SECAL each in FY91 and FY92.

6. Some political uncertainty in completing the processing on schedule does exist, particularly regarding the Cabinet approval of Railways Restructuring Plan now expected in February/March. GOP commitment is, however, sufficiently evident for us to proceed with appraisal in mid-February. Depending on the above, we plan to negotiate in April which would permit Board presentation in FY90.

Attachment

Cleared w/ and cc: Mr. Köpp (EM1DR).

cc: Mmes/Messrs.: Qureshi, Okonjo-Iweala (OPNSV); Stern ((FINSV); Husain (LACVP); Jaycox (AFRVP); Karaosmanoglu (ASIVP); Rajagopalan (PREVP); Fischer (DECVP); Shihata (LEGVP); Thalwitz (SVPPR); Wood (FPRVP); Vergin (OPNSV); Dubey (EAS); Lee (CODDR); Shakow (2) (SPRDR); Holsen (CECDR); Rao (2) (FRS); Thahane, Burmester (SEC); Liebenthal (SPRPA); Bock (DFS); Frank (CFP); Parmar (CIO); Pfeffermann (3) (CEI); El Rifai (MIGPA); Linn (IEC); Pouliquen (INUDR); Robless (OPNMS).

Mmes.Messrs.: Hasan, El-Maaroufi (EMN); Köpp (EM1DR); Dervis (EM2DR); Stoutjesdijk (EM3DR); Lari (EM4DR); Bouhaouala (EMTDR); Krishna (EM1DR); Kanchuger, Yap (EM1CO); Al-Khafaji (EMTIN); Baudon (EMTEN); Roa (EMTPR); Abe (EM1IN); Cuca (EM1PH); Batzella (EMIEG); Yoon (EM1AG); Nishimizu (EM1ID).
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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 9, 1990

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS V Dubey

EXTENSION: 78051

SUBJECT: PAKISTAN: Proposed Transport Sector Adjustment Loan
Initiating Memorandum

A meeting to discuss the Initiating Memorandum (IM) for the proposed Transport Sector Adjustment Loan to Pakistan will take place on Friday, February 16, at 3.30 p.m. in Room E-1243. The IM was circulated to you under Mr. Wapenhan's memorandum dated today. An agenda for the meeting will be issued shortly.

Distribution:

Messrs. Qureshi, OPNSV; Husain, LACVP; Jaycox, AFRVP; Karaosmanoglu, ASIVP; Wapenhans, EMNVP; Rajagopalan/Fischer, PPR; Shihata, LEGVP; Kashiwaya, CFSVP; Wood, FPRVP; Vergin, OPNSV.

cc: Messrs. Lee, COD; Shakow, SPR; Holsen, CEC; Rao, FRS; Bock, CFS; Picciotto, PBD; Burmester/Thahane, SECGE; Goldberg, LEGOP; Ms. Okonjo-Iweala, OPNSV; Kassum, CS2; El Serafy, EAS; Thalwitz, PPRSV; Parmar, IFC-CIO; Linn, IEC; Kavalsky, FRM; Pfeffermann, IFC-CEI; Liebenthal, SPRPA; Kilby, FRS; Robless, OPNSV; Ms. Haug, EXC; Khanna, EXC; Hasan, EMNVP; El Maaroufi, EMNVP; Kopp, EM1DR; Penalver-Quesada, EM1CO; Abe, EM1IN.

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THE WORLD BANK

Operations Committee

Minutes of the Operations Committee to consider
NIGERIA: Budgetary & Financial Policy Loan and
Public Enterprise Reform Loan
held on February 16, 1990 in Room A-1243

A. Present

Committee

Messrs. M. A. Qureshi (Chairman)
E. Jaycox (AFRVP)
K. Kashiwaya (CFSVP)
J. Wood (FRPVP)
J. Holsen (CECDR)
D. Goldberg (LEGOP)
P. Hasan (EMNVP)
R. Cheetham (AS5DR)
R. Martin (LACCE)

Others

Messrs. J. Adams (AF4CO)
A. Alizai (CA2DR)
S. Aiyer (AF4IE)
J. Barrientos (AF4DR)
F. Chaudhri (EAS)
P. Crevier (SECGE)
V. Dubey (EAS)
F. Earwaker (SPRPA)
P. Hansen (FRSCR)
R. Harris (CODOP)
A. Khanna (EXC)
C. Koch-Weser (AF4DR)
Ms. N. Okonjo-Iweala
A. Rigo (LEGAF)
Ms. J. Salop (AF4DR)
J. Todd (AF4CO)

J. Jimenez (IMF)

B. Issues

The Operations Committee met on February 16, 1990 to discuss the Initiating Memoranda (IM) for (i) the Budgetary and Financial Policy Loan (BFPL) and (ii) the Public Enterprise Reform Loan (PERL) for Nigeria in the amounts of $500 million and $250 million respectively. The discussion considered a number of points raised in the agenda issued by the Economic Advisory Staff on February 12, 1990.

C. Discussion

(i) Budgetary and Financial Policy Loan (BFPL)

At the outset the Chairman observed that the proposed operation was very comprehensive and being the last adjustment loan, it intended to carry forward the process of reform in some important areas like trade policy. He wanted to know what achievements should one expect in trade policy by the end of the loan period. The Regional staff first enumerated the earlier policy reforms (reduction in quantitative restrictions, elimination of import surcharge and licencing, and new tariff schedules) and institutionally-oriented reforms (Import Duty

Monitoring System, Tariff Review Board etc.) and then stated the objectives of the operation under consideration as being (i) further enhancement of the technical capabilities of the new institutions and (ii) further policy reform through the initiation of studies on a number of items - e.g. textiles, metal and engineering and other key subsectors, as well as on the economic cost of the remaining import bans. The Chairman asked if all that was intended was studies or some actions as well. The Region confirmed that the proposed studies would lead towards tariff changes in the 1991 budget, e.g. tariff reforms in the textile sector have to be accomplished before the release of the second tranche. The Chairman strongly emphasized that recommendations of studies should be translated into an actionable agenda, making clear what further rationalization of tariffs, in monitorable terms, should take place before releasing the second tranche.

Referring to the banking sector reforms, the Chairman again observed the comprehensive nature of the intended reforms and asked what prudential regulations will be covered in the action agenda. The Regional staff responded by saying that increasing capital adequacy requirements and strengthening their enforcement was a key element of the proposed program. Other measures included criteria for the classification of assets, accounting standards, transparency and scope of reporting, disclosure requirements/exposure limits etc. The objective was to bring prudential regulations to international standards.

One Committee member observed that the main trouble in the banking sector was the lack of financial discipline and warned that hasty steps cannot correct the current situation. The Region stated that it recognized that financial sector reform was a serious matter and that its approach was to focus on strengthening of accountability of bank managers through tighter supervision and capital adequacy requirements, even as a clean-up operation for insolvent banks begins. With respect to the latter, the Region informed the Committee that even though the Government wanted to start with only one bank (the largest insolvent bank having 120 branches), the Region has proposed that the restructuring program start with two banks. Another Committee member asked about the fiscal impact of the restructuring program. The Region indicated that the total lost portfolio amounted to $100 million, and that the annual fiscal cost of making up the losses -- essentially interest on the $100 million -- was small compared to the overall budget. These costs had been incorporated into the Region's budgetary forecosts. The Chairman advised the Region that in the interim the insolvent banks, not subject to restructuring, should be allowed to function only on a limited basis. He also stressed that the necessary legislative steps, amendments etc. that would be accomplished by the end of the reform process should be clearly spelled out in the loan documents.

One Committee member asked about the second tranche conditions relating to "satisfactory overall macro framework" and maintenance of appropriately valued exchange rate. Responding to the question, the Region stated that while it was not possible to quantify precisely at this time what would be achieved, further progress on inflation and in narrowing the gap between the official and parallel market rates would be essential. The Region indicated that a repeat of the 1988-type expansion -- which in the event had delayed the negotiations and processing of the Trade and Investment Policy Loan -- was clearly not acceptable and much depended on the Fund judgement in this respect. The Fund representative stated that the monetary policy must remain tight because of concerns regarding inflation; meanwhile, a 3-4 percentage point reduction in the budget deficit would be aimed at partly through increases in non-oil revenues. While the current nominal exchange rate was not far out of line, maintaining it in line with inflation would be essential. The Fund noted that the potentially expansionary impact of financial reforms would need to be closely watched. Overall the targets of the last year were met and the prospects for similar performance, according the Fund representative, were good.

Turning to the question of arrears, the Chairman observed that the Bank had not taken a position and wanted to discuss the matter with the Fund and to ascertain the government's preferences in this respect. He, however, felt it would not be prudent for the country to drift into an across-the-board arrears situation as a negotiating tactic.

Finally, the Chairman observed that BFPL being one of the largest Bank loans with lots of issues, caution must be exercised in its processing and that sufficient time should be taken to prepare it properly and to make it clear what is to be achieved through this operation.

(ii) Public Enterprise Reform Loan (PERL)

The Chairman opened the discussion by saying that while the concept of PERL was quite simple, its implementation would be rather difficult. Overall the program represented a good menu of privatization and commercialization of public enterprises but it was not clear what specifically did the Region want to achieve.

The Region informed the Committee that the operation under consideration was essentially a home-grown program with lots of upfront actions. The Chairman felt that while it was not necessary to specify how many public enterprises (PEs) would be privatized/commercialized, it was essential to present a clear cut program as to what must be accomplished by the time the second tranche is up for consideration.

Referring to the hybrid nature of the proposed operation with an investment and a quick disbursing policy component, the Chairman advised the Region that 'hybrids' should be designed only when sectoral policies are intended to reinforce the investment component and vice-versa. Ideally, he said, the quick disbursing part should represent the costs (in terms of impact on the balance of payment) that results from a particular operation.

The Region informed the Committee that its intention was to deal with the sector policy and investment issues in one framework. The Chairman informed the Region that it could treat the proposed operation as a sector investment loan but in that case it would not have a quick-disbursing component and would have to be anchored on a positive list. The Region informed the Committee that after carefully considering the various options and taking into account the Chairman's remarks, it will again review the shape and design of the proposed operation.

One Committee member showed concern regarding the ambitious nature of the program and the underlying financing plan. The Region noted that while the program looked ambitious, the Nigerians had shown that they could handle it. In 1989, the private sector offers on the first set of 5 companies were four times over-subscribed. Another set of 14 companies was also sold on the stock market without much difficulty.

Following these deliberations the Region was authorized to appraise the two operations as discussed.

February 23, 1990
FMChaudhri:gs

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

900213014 1.

DATE: February 12, 1990

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXTENSION: 78051

SUBJECT: NIGERIA: Agenda on: (i) Country Strategy Paper (CSP)
(ii) Budgetary and Financial Sector Policy Loan (BFPL)
(iii) Public Enterprise Reform Loan (PERL)

The Operations Committee will meet on Thursday, February 15, 1990 at 4.30 p.m. in Room E-1243 to consider the above-mentioned documents on Nigeria. The main focus of the agenda is on the Country Strategy Paper with questions on the other two documents addressing mainly the key operations-specific issues.

Background

The oil boom of 1970s gave rise to large increases in incomes and public expenditures with many public sector investments having been undertaken without much attention to their economic viability. The exchange rate was allowed to appreciate, distorting the relative prices, and terms of trade moved against the agricultural sector. Subsequently, when the oil prices were depressed in the early 1980s, the government revenues collapsed, and sizable internal and external imbalances surfaced, leading to acute economic crises and rapid increases in debt obligations. The austerity measures that were introduced in mid-1980s reduced the fiscal and external deficits but economic growth and employment suffered heavily.

The government entered the second half of the 1980s with a far-reaching structural adjustment program (SAP) - aimed at stabilizing the economy, while restructuring and diversifying its productive base. However, the collapse of oil prices in 1986 coincided with the SAP and created difficult circumstances for program implementation. Notwithstanding these difficulties the Government persisted with and sustained the adjustment program: depreciating the real exchange rate substantially, abolishing import licenses; freeing prices and marketing arrangements for agricultural products; rationalizing the public expenditure program, initiating the privatization and commercialization of public enterprises and adopting policy statements/action programs for a large number of economic and social sectors including the environment.

The outcome over the past three years has been encouraging. There have been positive results in agriculture, manufacturing and non-oil exports. Overall, the resource use is more efficient and economic incentives are more in line with Nigeria's resource endowment than before. However, the unfinished agenda remains extensive: monetary and fiscal discipline need further attention, inflation is worrisome, the exchange rate determination should be made more market based, and the debt management issues need to be addressed. The longer term issues of raising the agricultural productivity and growth rate and containing the growth rate of population with clear and sufficient attention to environmental hazards require courageous and challenging initiatives.

(A) The Country Strategy Paper

The Macro-economy and Sectoral Outlook

Basically, the growth scenario consists of the base case with two downside risks - the oil price collapse and domestic policy slippage - dealt separately in an annex. The base case itself is predicated on a continuation of recent economic policies and improvements in economic efficiency coupled with debt restructuring.. The scenario envisages an average annual rate of growth of non-oil GDP of 4.6% based on real import growth of 6.5 percent per annum.

Most projections look optimistic. In particular the Committee may wish to ask the Region to explain how realistic is it that over the 1988-97 period: ✓

- total investment would rise from 12 percent of GDP to 19 percent (in current prices) compared with its rather low level of less than 10 percent over the previous four years period. Is the projected increase in public sector investment - from 8% to 12% of GDP - desirable and are we confident that it will be invested in good projects?

- Should not an increasing share of higher oil revenues be better applied to reducing the Government's domestic debt to the banking sector - enhancing financing of private investments - and/or lowering the burden of external debt?

- private investment would rise from 4 percent to 7 percent of GDP even though it is stated that the "private investment response has so far been disappointing";

- Non-Oil exports are projected to increase from $900 million in 1989 to $2.5 billion in 1997 while over the previous 10 year period these were only slightly over $600 million a year. Which are the non-oil products that have high supply potential on competitive basis and favorable marketing prospects?

- 40-45 percent inflation in 1988-89 will be brought down to 10 percent or so within the next two years.

- much of the sources of the economy's growth would come for projected agricultural growth of 3-4 percent per year but according to the CSP (para. 11) the issue remains, "how to ensure adequate private investment directly in agriculture and in commercially viable input distribution, financial and marketing services in support of agriculture in order to elicit a strong and sustainable production response".

What strategy would achieve a satisfactory progress in all these areas?

- manufacturing is projected to have the highest projected growth rates - averaging over 8 percent per year from 1990-97 while the level of its contribution to GDP (at constant 1984 prices) did not improve at all during the 1980s.

- Is not there a substantial risk that these optimistic projections would not materialize?

Public Sector Projects and Implementation Capacity

A considerable part of Nigeria's previous economic difficulties was the result of many public sector projects for which economic viability was clearly questionable. Even in more recent years it appears that despite an agreement on the general criteria for selection of projects, there has been disagreement over specific public sector projects. It implies that the general criteria have not been effectively applied to select economically most viable projects.

- Is the Region satisfied that the system and procedures are in place that would be effective in blocking the economically unviable projects?

- How far has the country succeeded in eliminating "problems related to institutional capacity, bureaucratic layering, cumbersome procedures, and highly centralized decision-making?"

- Can the Bank expect substantial improvement in the implementation capacity and speed of disbursements over the program period?

The Proposed Lending Program

The CSP proposes a base case lending program of US$0.9 billion rising to $1.1 billion in 1994 which represents a significant (around 25 percent) drop from the US$1.0 - 1.5 lending program previously being considered. This includes a quick disbursing lending of $250 million per year in FY1991 and FY92 increasing to US$350 million in FY93 and FY94. The policy focus of these loans will shift to sectoral adjustment operations.

- Given the amount of macroeconomic adjustment that still remains to be accomplished, is a shift to sector adjustment lending warranted at this stage? What vehicles will the Bank have for continuing a macro-economic dialogue with the Government?

Following this year's Budgetary and Financial Policy Loan (BFPL), future adjustment operations would cover Public Enterprise Reform Loan (PERL), fertilizer policy, the environment, the financial sector and population policy. The proposed project lending would split roughly 75 percent for growth and 25 percent for poverty/human resources oriented operations.

- The Region might shed light on Government's continued ability and willingness to continue policy reforms. In the event the progress on the proposed policy agenda proves difficult would the lending program be self-adjusting? What would be the key triggers determining Bank posture in different circumstances?

CAM Resources

The Region's CAM allocation for Nigeria assumes some growth over FY91-93, with the FY90 budget of 48 staffyears rising to 52 staffyears in FY93. In view of the severe implementation problems dramatized by the poor performance of the Bank's lending program, the Region proposes to increase the number of supervision staffweeks per project by 20 percent during FY90 and maintain it at that level over the next few years.

The staffyear allocations are projected to decline over FY89-FY93 for lending from 22 to 20 and for ESW from 12 to 11.

- The Committee may wish to consider whether, in light of the significant drop in the proposed level of lending and limited inclusion of staff-intensive adjustment operations within the program, the proposed increase in CAM resources is justified and whether the proposed allocation between the supervision, lending and ESW activities is appropriate.

Financing Plan

The proposed financing plan is rather ambitious. It assumes continuous "shadow" IMF programs to sanction regular rescheduling of principles by Paris Club; substantial balance of payments support from bilateral sources, launching of the Brady initiative with 70 percent discounts, etc.

- What are the prospects of the total financing package materializing the way it is envisaged?

Debt and the Brady Initiative

By the end of 1988, Nigeria's total external debt reached US$32 billion. Of this, 19 percent was owed to commercial banks, 48 percent to the Paris Club and creditors guaranteed by Paris Club participants, 9 percent to multilateral institutions (primarily IBRD), and 18 percent to uninsured private creditors. Nigerian debt is heavily discounted in secondary markets; the discount dropped from 80 percent to 70 percent in late 1989. Total net transfer (disbursement minus debt service) from external private creditors are negative throughout the forecast period. Without a Brady initiative reduction program, the negative net transfer from the London Club would be large, averaging some US$600 million per annum, even after rescheduling. In the base case scenario a large scale Brady initiative is assumed to replace all commercial bank debt financed in part by US$200 million in new lending from the Paris Club and $250 million from the IMF (para. 39).

- The Committee may wish to discuss whether Nigeria's debt profile and service obligations warrant a Brady initiative debt reduction operation at this stage and whether the Region's initial ideas in this respect are in the right direction.

Bank Exposure and the Country Risk

In the base case scenario total World Bank (IDA and IBRD) exposure would increase from $2.8 billion at end-1988 to US$7.4 billion at end-1997. This implies an increase from 9 percent of total debt to 22 percent (17% for IBRD). The IBRD's share of total public debt service (counting rescheduling credits as reductions from debt service payments) would also increase from 14 percent in 1989 to 22 percent in 1997. IBRD debt service as a percent of exports, however, would decline 5.5 percent in 1988 to 4.4 percent in 1997. including

- The exposure limits are close to the guidelines but if the downside risks set-in and the Bank's relative contribution rises to higher levels, would not the exposure and country risks become problematic?

IDA

more resp[illegible]
[illegible] 44

Next CSP

When and in what form the next CSP should be prepared.

B. Budgetary and Financial Policy Loan (BFPL)

The Region has sought the OC authorization to appraise the proposed BFPL for $500 million as the third .... and last ..... in a series of large SAL-type operations in support of the Nigerian Structural Adjustment Program (SAP). BFPL is intended to support the completion of the structural adjustment agenda: lowering of inflation, making the exchange rate more market-determined, improving the trade policy and price signals, rationalizing the public sector investment programs, reforming the federal tax system etc. In a new initiative, BFPL would address on the financial sector issues and measures to alleviate the social cost of adjustment. The agenda below focuses on the financial sector component of BFPL and its linkages to the Public Enterprise Reform Loan (PERL) - another proposal submitted for the OC consideration.

BFPL's Financial Sector Component

The Region notes that the Nigerian banking system has serious portfolio weaknesses, which reflect management shortcomings, lack of commercial accountability and weaknesses in the regulatory system. To alleviate these problems the proposed operation seeks to (a) introduce a more realistic and prudent minimum capital adequacy requirement, (b) agree on an action program to increase effectiveness of central bank supervision, and (c) support a bank restructuring program.

The Region has proposed a minimum 8% capital to risk assets ratio which is consistent with the international standards for the developing countries. However, capital adequacy would lead to strengthening of the solvency of banks if it is also supported by prudential guidelines on other equally important aspects, such as exposure limits, classification of assets, income accrual and provisions for doubtful debts.

- The Committee may ask the Region to clarify whether other existing rules governing prudential guidelines also need to be brought to international standards and if so, will they be included in the scope and conditionality of the proposed loan.

The Region has rightly given a high priority to the restructuring of banks. In most countries undergoing adjustment process and which have faced major economic shocks such as Nigeria, the banks usually absorb most of the financial losses caused by distress in the real sector. The situation is further exacerbated, in such countries, by the presence of government-owned banks which are generally more susceptible to portfolio losses due to government interference. Therefore, it is not surprising that Nigerian banks are faced with solvency problems and that state-owned institutions "are clearly in the worst position ......" The Region reports that seven banks are technically insolvent and that "several other banks would be technically insolvent if more prudent provisioning rules are adopted". The proposed bank restructuring program included in the loan relates to seven banks known to be insolvent and consists of steps that would lead to commencement of implementation of the restructuring plan by second-tranche release. While this approach generally makes sense, the Committee may ask the Region to elucidate the following aspects:

- Is it possible to expand the number of banks under the restructuring program, considering the critical importance of early restoration of the solvency of the banking system and the large size of the proposed loan?

- Is the requirement (Annex 1, page 4) that restructuring program implementation commence by second-tranche release enough? Is faster progress possible?

- What measures beyond mere financial restructuring are to be taken to ensure that state-owned banks will have autonomy to operate as business organizations and that factors responsible for their problems will be permanently removed?

C. Public Enterprise Reform Loan (PERL)

The proposed loan is for $250 million. In accordance with its twin objectives of supporting general policy reforms and enterprise restructuring, the loan will finance general imports ($125 million to be disbursed in two equal tranches) and the restructuring program of selected PEs to be commercialized ($123 million) with $2 million allocated for financing technical assistance and training needs of the

Technical Committee for Privatization and Commercialization (TCPC) and other agencies related to the PE reform process.

The two main components are privatization of public enterprises (PEs) without a particular public purpose, and commercialization of the remaining enterprises that provide public services. A total of 67 enterprises are slated for full privatization in which Government will dispose of 100 percent of its shareholdings. Thirty-five PEs, typically those that provide public services are to be commercialized partially or fully. Already, seventeen PEs, mainly in agro-industries, have been privatized since the program was announced in 1986. Similarly, diagnostic work on 32 out of the 35 targeted enterprises has been completed. The Bank has played a substantial supportive role in the shaping of Nigeria's PE reform program by undertaking two sector reviews, public expenditure reviews, sectoral operations and Technical Assistance Projects.

A public enterprise reform program of the size proposed will inevitably have major implications for the financial sector. In order to impose financial discipline and commercial orientation on public enterprises, existence of a strong and independent financial sector is essential. Moreover, it is very likely that the proposed restructuring of the public enterprises (particularly those to be closed) would have a direct impact on the portfolio of financial institutions. Finally, a program of this nature provides an opportunity for the government to minimize its ownership of banks and other financial institutions which have not performed well. The Region may be invited to comment on:

- the implications of the public enterprise reform program for the financial sector and
- the possibility of the Government further reducing its shareholding to a minority position in commercial (from proposed 51%) and development banks (from proposed 70%) if total privatization is not possible.

Amounts of Loans

The proposed loan amounts are quite large: $500 million for BFPL and $250 million for PERL.

- What is the Region's rationale for the proposed amounts of loans and is the range/depth of conditionality in the two operations commensurate with the amounts of loans.

Operations Committee

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Wapenhans
Rajagopalan/Fischer, Shihata, Kashiwaya, Wood, Vergin

cc: Messrs. Lee, Shakow, Holsen, Rao, Bock, Picciotto, Burmester/
Thahane, Goldberg, Chaudhri, Ms. Okonjo-Iweala, Thalwitz,
Parmar, Linn, Kavalsky, Pfeffermann, Liebenthal, Kilby,
Robless, Ms. Haug, Khanna, Agarwala, Aguirre-Sacasa,
Koch-Weser, Adams, Tariq Husain

FChaudhri/KSiraj:gs

February 16, 1990

Mr. Moeen A. Qureshi:

For the OC Meeting on Friday, February 16, 1990 at 2.30 p.m.

Re: NIGERIA: (i) Budgetary & Financial Policy Loan (BFPL)
(ii) Public Enterprise Reform Loan (PERL)

Some Additional Points

(i) BFPL

- BFPL aims at maintaining the macro-economic policy measures of the previous two adjusted operations, rationalizing the public investment programs, reform of tax administration and policy, comprehensive reform of the financial sector and alleviation of the social cost of adjustments.

- The scope and coverage has multiplicity of objectives and diversity of components. Given the already strained implementation capacity, is not there a need to sharpen the focus and prioritize the action program?

- Most conditions for negotiation/board presentation appear to relate to agreements on procedures, studies and provision of information and a large part of the substantive conditionality appears to be back-loaded with little upfront actions. The Region may be asked to have another hard look at conditionality.

(ii) PERL

- The proceeds of the quick disbursing portion of the loan would be available in two equal tranches. Continued disbursement under the investment part (mainly relating to enterprise specific rehabilitation programs) will also be conditional upon the satisfactory performance of the policy part of the loan (para. 34).

  Does it not run the risk of delaying and hampering the investment component?

- The program of divestiture envisaged in this operation is quite ambitious. Given that the financial sector itself will be subject to restructuring under the other operation (BFPL), will the commercial banking sector and the local capital market have the capacity to handle the divestiture program?

- A large number of the second tranche release conditions are couched in terms of "satisfactory progress". This may become problematic when assessing the grounds on which the tranche is to be released. Should not most of the conditions be made more specific and monitorable?

Dubey

Vinod Dubey

A

FMChaudhri:gs

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: February 15, 1990

TO: Mr. Caio K. Koch-Weser, AF4DR

FROM: Koji Kashiwaya, CFSVP

EXTENSION: 70795

SUBJECT: NIGERIA: Observations on the Proposed Brady Plan in the CSP

I read with great interest the Country Strategy Paper, the Budgetary and Financial Policy Loan document and the Public Enterprise Reform Loan paper. I would like to commend departmental staff on the thoroughness, breadth, and frankness of their analyses and on the quality of the presentations. While there are many interesting issues which could be addressed, I will largely confine my remarks to a few observations on the proposed Brady Plan workout and on the potential for a more strategic approach to the debt issue and its implications for the privatization program.

I wish to take this occasion to make a few observations about how best to include discussions of Brady proposals in a CSP. I hope that the approach that we adopt can serve as a model for other countries. First, the presentation of the debt situation and the debt reduction proposals appear throughout the CSP. It would improve the clarity of the presentation and the integrity of the discussion of the issues if all of the elements were pulled together in a single section on external financing and debt management strategy. Second, we would prefer to see more emphasis on setting out the strategy for debt reduction in the section devoted to that topic. Some of the elements of this approach are already present in Annex 1 (Commercial Bank Debt Reduction) of the paper. However, the strategic elements of the approach could be strengthened by giving more emphasis to the overarching issues (e.g. How much debt service can Nigeria afford? What happens if the country must accumulate arrears?), rather than to tactics (e.g. Which combination of debt reduction options would best meet Nigeria's debt reduction goals?) These specific tactics are too fluid to have a place in a strategy paper, but alternatives under consideration could well be attached in an annex.

With respect to the debt strategy of Nigeria, we need to further explore with the Nigerian authorities and with its creditor banks the range of debt reduction options which would be acceptable to both parties. However, I perceive that the following points will be salient to the nature of negotiations between the Government and its commercial creditors. First, due to the character of past negotiations, creditor banks have a negative impression of the Nigerian government. They will therefore be unwilling to offer new money as part of a debt workout. Even some of the British banks which have historically included Nigerian debt in their portfolios (e.g. Barclays and Lloyds) have sold off their Nigerian paper. In this respect, Nigeria is different from Mexico and the Philippines.

Second, despite the lack of cordial creditor bank relations, there is enormous potential for private investment in Nigeria in the long run, given its natural resource base, large domestic market, and pool of skilled labor. Therefore, insofar as feasible, debt reduction schemes should be formulated to be conducive to promoting private investment and project financing. We should continue to examine means of linking a menu of debt reduction options to support for the Government's ambitious program of privatization. In this respect, it should be noted that a debt reduction program for Nigeria would be different from that of Costa Rica in which a debt buyback was the centerpiece of the deal.

Third, because commercial creditors are principally European and United States banks (a creditor composition different from that reflected in the three existing Brady debt workouts), it is likely that some banks may prefer debt service reduction to a buyback because of tax and regulatory considerations.

Given these factors, we expect that a debt reduction menu may consist of:

(a) a buyback;
(b) debt and debt service reduction; and
(c) debt conversion (debt for equity or debt for project financing).

I also wish to take the occasion of the review of the CSP to underscore the desirability of early consultation on debt reduction strategy between the CDs and CFS, which would facilitate the inclusion of such a strategy section in the CSP. While CD and CFS staff have consulted regularly since the development of the Brady Initiative, the circulation of the CSP represents the first occasion for concretizing what have necessarily been open-ended discussions in the absence of clear indications from the Nigerian government. Assuredly, the earlier the Bank can define and present its views to governments, and thereby bring some realism to a government's decision making process on debt reduction alternatives, the better. We feel that that process would be facilitated by making sure that the units of the Bank which are concerned with devising strategy on debt reduction agree as early as is feasible on a realistic approach to solving this problem.

I place great importance on finding a solution to Nigeria's debt problem. If a Brady package is feasible for Nigeria and it can come to terms with its commercial creditors, the door may be opened for finding solutions to the commercial debt problems of other similarly situated African countries. I look forward to further collaboration in this domain.

Cleared with and cc: N. Paul (Acting Chief, CFSFA)

cc: Mr. M.A. Qureshi, Mr. Jaycox
Messrs. J. Adams, J. Todd, D. Bock, J. Shilling, I. Elwan, A. Toft
Ms. J. Salop

YJones:lrd

February 9, 1990

2. Mr. Qureshi
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THE WORLD BANK
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee to Consider
POLAND - First Structural Adjustment Loan (SAL I)
Initiating Memorandum

Held on Friday, February 9, at 12:00 P.M. in Room E-1243

A. Present

Committee

Messrs:
M. Qureshi, Chairman
H.N. Scott, LEGVP
D.J. Wood, FPRVP
S. Fischer, DECVP
K. Kashiwaya, CFSVP
R.J. Cheetham, ASI
E.V.K. Jaycox, AFRVP
W. Wapenhans, EMNVP

Others

Messrs./Mmes.:
E. F. Lari, EM4DR
V. Dubey, EAS
R. Harris, COD
P. Hasan, EMNVP
U. Thumm, EM4DR
D. Goldberg, LEG
N. Okonjo-Iweala, OPNSV
P. Nouvel, EM4CO
E. Grilli, EAS
M. Lav, EM4CO
J. Loos, EM4CO
J. Toureille, EM4EI
P. Ljung, EAS
G. Olivares, FRS
C. Obidegwu, SPRPA
P. Hole, IMF

B. Issues

1. The Operations Committee met on February 9, 1990 to discuss the Initiating Memorandum for the First Structural Adjustment Loan (SAL I) to Poland in the amount of $300 million. The agenda comprised the issues of enterprise ownership, enterprise restructuring and privatization, creation of a securities exchange, monopsonistic marketing structures, conditionality in the environmental area, flexibility in SAL implementation, potential failure of the stabilization program, and the loan amount and financing plan.

C. Discussion

2. The Chairman began the meeting by asking the Region to discuss the priorities of the adjustment program and the proposed loan. The Region responded by first describing the context including the bold but risky stabilization program being pursued by Poland. While the need to reduce inflation was the priority, the impact of the program on output and employment was uncertain but likely to be substantial and it was therefore important to quickly implement policy and institutional measures that would promote the supply response which is precisely what the proposed loan would be focusing on. The SAL would in particular promote creation of a competitive system, breaking up monopolies, development of small and medium enterprises, and enterprise restructuring (including privatization). The social costs of adjustment would also be specifically addressed. A participant added that the SAL would also be supporting a sound macro-economic development plan and that while this is given for the current year by the IMF supported stabilization program, the framework for latter years would need to be established by the SAL.

3. The Chairman enquired as to our minimum expectations for the three main areas (enterprise ownership/restructuring, financial sector development, and social safety net) to be addressed by the SAL. The Region responded that the new legal framework would need to clearly define the ownership of enterprises, create a competitive/anti-monopoly framework, improve competition in agricultural marketing/processing, and clarify and improve bankruptcy regulations. The costs of enterprise restructuring in response to the newly emerging market system would need to be estimated much more precisely and funding defined in terms of the macro-economic framework. In the financial sector, improved prudential regulation of the commercial banks, improved auditing/accounting practices, and strengthening of the central bank and commercial bank operations would be important. Concerning the social safety net, a more accurate estimate of needs would be required, as well as a revision of the formula to determine payment levels (government had recently accepted a formula based on wages received during the last job rather than payment based on needs related to the poverty level). These restructuring and social costs needed to be estimated and fully funded in the budget and provided for in the macro-economic framework. Regarding the last point, government had allocated less than 2% of GDP through two schemes for social costs whereas our preliminary estimates suggested that closer to 4% of GDP would be required.

4. The Chairman stated that the SAL would need to focus on three issues. First, it was essential that factor mobility be increased. In this regard, improved institutions were important but incentives were even more important; could interest rates and other factor payments be freed up quickly? Second, given the comprehensive stabilization program, there was a need to go beyond classical social safety nets to targeted programs. Could the SAL support specific visible programs such as nutrition programs for children? Third, could the SAL support quick income-generating programs, like promotion of mini and small enterprises? The Region, referring to the question of factor mobility and freeing up interest rates, suggested that some caution was needed because managers of loss making public enterprises could easily proceed with distress

financing at high, above market interest rates, particularly using "nomenclature" connections, and then would crowd out other possible credit-takers with more profitable ventures. A member suggested that a well-functioning financial sector was the key for factor mobility, but that if state enterprises were privileged bidders, there was a need to ensure that others could participate in the bidding for capital in a fair and open manner. A member added that the priority given by the SAL to privatization and enterprise reform seemed entirely appropriate to address this concern.

5. A member asked if Poland could really afford a social safety net that would eliminate absolute poverty. The Region responded that we would work with government to identify an appropriate poverty level which would allow an affordable but effective social safety net to be established. The members commented that this might not be easy without jeopardizing the macro program, while another member stated that in many non-European countries support levels requiring the 4% of GDP mentioned for Poland could not be afforded, and eliminating absolute poverty was not a feasible target at this stage. The Chairman stated that it would be necessary to be professional in our assessment of needs and affordability, and that we would need to strike the right balance between the two.

6. Turning to the enterprise finance issue, a member was concerned that if banks did lend to enterprises which were in financial distress and thus showed an inability to assess enterprise requests for financing objectives, there could be a chaotic financial situation. What efforts were made in that area? The Region responded that a great deal of work was ongoing in this area, to strengthen the ability of the banking system to cope with these problems. Support had been mobilized from our resources, the IMF, the central banks of England, Italy, and France, and other sources.

7. A member asked about the condition stated in the Initiating Memorandum that by Board presentation of the SAL, it was expected that legislation would have been passed to allow enterprises to operate efficiently. He felt that this was a laudable objective, but wondered whether it could be achieved in practice. Turning to the program supported by the IMF, the members asked for a clarification of the measures which would reduce the fiscal deficit, and whether any information was available on performance during the short period of time that the program had been in effect (from January 1, 1990). The IMF participant responded that there would be some expenditure reduction, based on a reduction in subsidies, although increases in debt service and social safety net expenditure would partially offset this. Concerning the second question, the member noted that there had been some contraction in credit as enterprises responded to the higher interest rates, that a large amount of dollars had been exchanged for zlotys (as had been foreseen in the program), and that there had been no loss in reserves nor recourse to the $ 1 billion stabilization fund.

8. Turning to the question of the micro/macro interface and the need to firm up our estimates of the cost of enterprise restructuring, regional staff confirmed that the Region would be allocating more resources to this question, to defining and implementing operational plans to promote such restructuring,

and to ensuring adequate provision in the budget and macro-financing plan for this activity.

9. A member stated that in view of the large uncertainties in this regard, it would be extraordinarily risky to allocate large amounts of fast-disbursing funds; was fast-disbursing IBRD financial support really required? It was clear that Poland was not now creditworthy, and we needed an expectation, not just a hope, reduction in the official claims on Poland would take place. If debt reduction affecting official creditors were to be implemented, was there a risk that we would be included if we had not obtained - in advance - specific assurances to the contrary? The member felt that without firm assurance on official debt reduction, it would be very risky for us to proceed.

10. The Chairman responded that we would not go to the Board to propose the SAL without substantial progress towards resolution of this issue, which he had personally discussed with Mr. Trichet of the Paris Club, and that it was expected that the Paris Club as a first step would go for a one-year agreement which would be generous in terms of giving 100% or close to 100% debt relief (provided the London Club accepted a similar arrangement). The member who had raised the issue responded that we really needed something more than 100% interest capitalization - since this merely pushes the problem into the future. An agreement that reduces the burden of the debt is what is needed. The Chairman stated that the Paris Club will almost certainly go for total debt relief for short periods (perhaps successive one-year periods), but that they do not yet want an agreement on long-term restructuring that would set a precedent for other countries. A member asked if Poland would continue to pay interest to the commercial banks while not servicing Paris Club debt. The Chairman stated that Mr. Trichet had informed him that the Paris Club creditors would not proceed unless the London Club acceded to terms similar to those of the Paris Club. It was clear that the bilateral creditors were willing to go quite far in helping Eastern Europe and Poland in particular in this regard, but that the issue of debt reduction would only be clarified during the next year and not immediately.

11. A member noted that Poland's external debt position was worse than all countries in LAC (except perhaps Peru), and that if Poland were a LAC country we would insist on an agreement of the London Club and the Paris Club concerning debt service and debt reduction before presenting a SAL to the Board. Were we justified in moving on the SAL? Another member suggested that since Poland's commercial debt was selling on the secondary market at a very large discount, perhaps a debt repurchase program would make some sense. A member observed that an arrangement allowing capitalization of unpaid interest would not by itself adequately address this issue since this would increase the stock of debt. The Chairman concluded discussion of this subject in stating that we could not make much more progress on this issue at the present time, but that the Paris Club meeting to be held on February 14 could offer some guidance for our thinking, and that we could return to a discussion of the issue subsequently.

12. Turning to the question of the legal framework for financial sector adjustment, a member noted that the needed changes in the banking law and prudential regulations would take some time, and that creating an adequate legal

framework for enterprise competition would also be a difficult task. The Region pointed out that we had been working on this issue for some time (including a mission which was now in the field), and that a resolution of the ownership issue was needed right from the start. If there was an inadequate framework, we would not proceed with the SAL. The Chairman stated that this was absolutely essential, and that we would need a very clear understanding and a satisfactory framework before proceeding. We would also need satisfactory progress on reducing monopsonistic marketing structures. Concerning the securities market issue, the Chairman stated that it was important to set up a legal framework to allow sale of securities, but that a formal securities exchange was not an urgent requirement.

13. A member enquired as to the basis for a fast-disbursing operation, since it was not obvious that our funding was really needed to ensure adequate balance of payments support. The Region stated that SAL disbursements were in the financing plan for the stabilization program being supported by the IMF Stand-By. In fact, the Polish authorities had requested that the loan amount be larger. The Chairman stated that there was no basis for increasing the loan amount, and that the proposed $300 million would need to be carefully justified in terms of balance of payments financing. The Region stated that Poland did not have excess resources, even with the SAL as proposed.

D. Conclusion

14. The Region was authorized to appraise the SAL for an amount of $ 300 million. Special attention would be given to firming up the financing requirement of the social safety net and enterprise restructuring, and ensuring that the macro-economic financing plan was consistent with the identified needs. Concerning the social safety net, targeted programs and employment generating programs would need to be identified. The SAL would need to be firmly justified in terms of Poland's balance of payments needs. Finally, the forthcoming Paris Club meeting would provide important indications on Poland's creditworthiness.

MLAV:jeb

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

90020701 7 1.

DATE: February 7, 1990

TO: Mr. Moeen A. Qureshi

FROM: Vinod Dubey, Director, EAS V. Dubey

EXTENSION: 78051/2

SUBJECT: POLAND: Structural Adjustment Loan Initiating Memorandum - Agenda

(1) When they come back we shall need to know what we can do.

(2) What would they like to see done

(3) Review this once again.

(4) Macro program will fail

1. The Operations Committee will meet on Friday, February 9, 1990 at 12:00 noon in Room E-1243 to discuss the Initiating Memorandum for the Structural Adjustment Loan to Poland. The document was circulated to you under Mr. Wapenhans' signature on February 2, 1990.

Background

2. Starting in 1988, the Government initiated a number of significant institutional reforms. A new legal framework supporting private sector activities and foreign investments was established, central allocation of resources reduced, agricultural prices and processing liberalized, and the banking system reformed. However, fueled by political turbulence, the economy deteriorated alarmingly in 1989. Inflation accelerated from about 70 percent during all of 1988 to 40-50 percent per month during the final part of 1989. The budget deficit quintupled to about eight percent of GDP. After having grown by about five percent the previous year, GDP declined by two percent. The current account widened and arrears--especially to Paris Club creditors--accumulated.

3. The coalition government that assumed office on September 12, moved quickly and decisively to arrest and reverse the deteriorating situation. At the same time, it moved forward with radical reforms to transform the economy to a market based system where the private sector is expected to play an increasing role.

4. In early January, the Government implemented a drastic stabilization program supported by a Fund standby arrangement (approved on February 5, 1990). It freed all but about 10 percent of all prices; significantly raised most of the remaining controlled prices (coal by 400-600 percent, electricity by 300-400 percent); raised interest rates to a level that was expected to exceed the average inflation rate for January and February; introduced a restrictive wage indexing system; essentially balanced the budget (in part through major reductions in subsidies); imposed tight credit controls; liberalized virtually all current account transactions, and devalued--and fixed--the zloty. The most significant outcome of the program is an anticipated fall in the inflation rate from 45 percent to 1-2 percent per month by the end of the second quarter. Most of the associated structural measures will be supported by the Bank's proposed SAL.

(1) Supply response will be slow.

(2) Monopolistic marketing system

5. The objectives of the SAL are: stabilization, structural reforms towards the establishment of a market economy to improve resource allocation and resume growth, and progressive restoration of credit worthiness. The program is still somewhat open, but it is proposed to focus on:

(i) enterprise restructuring, privatization and private sector development with emphasis on appropriate legislation and the establishment of an adequate institutional framework for enterprise restructuring;

(ii) financial sector reform with emphasis on improved bank regulation and supervision, introduction of adequate accounting and auditing standards, and strengthening and ultimately restructuring of the banking system; and

(iii) social safety net with emphasis on adequate unemployment benefits and a program of minimum social assistance.

Supplementary measures are proposed in the fiscal and trade policy areas. A noteworthy feature is the introduction of environmental actions in the policy matrix.

Issues

6. Against this background, the Committee might want to consider the following issues:

* Enterprise ownership. Without well defined owner interests, it is likely that other reforms aimed at improving enterprise efficiency (such as bankruptcy legislation) will have only limited results. The draft legislation related to enterprise ownership envisages three main types of entities: joint stock companies, socialized enterprises and worker-owned entities. At present, the equity in Polish state enterprises can be divided into two parts: the "founder's fund" and the "own fund". The founder's fund belongs to a sectoral ministry or other socialized enterprises and it has typically been severely eroded by inflation. Although interpretations differ, the own fund in practice belongs to the workers. Consequently, there is a significant risk that a large number of the restructured enterprises will be shaped in the Yugoslav mode. All indications are that this would seriously jeopardize the stabilization program and the prospects for future growth. The Region might want to explain (i) what is the Government's present thinking on the ownership issue; (ii) what concrete steps are planned to define present ownership rights and to establish procedures for the transfer of these rights, and (iii) what criteria will be used by the Bank to evaluate if the proposed solutions are consistent with the stabilization and adjustment objectives.

flows of labor + capital

* Enterprise restructuring and privatization. The most recent economic memorandum estimates that perhaps as much as one-third of Polish industry is non-competitive by world market standards. The economic reform program liberalizes foreign trade, raises taxes and interest rates and virtually abolishes subsidies to enterprises. Consequently, even without major changes in ownership patterns, the need for enterprise restructuring is likely to be massive. The Region might be asked to explain (i) what analyses have been or will be carried out to assess the impact of the reform package on the financial health of enterprises and the resulting restructuring needs, and (ii) what action will be taken to assess the situation of major public enterprises and to develop specific restructuring plans at an early stage.

* Creation of a securities exchange. The establishment and growth of private enterprises and the privatization of state owned enterprises will over time require the mobilization of massive investment resources. The creation of a securities exchange is probably a precondition for effective resource mobilization. The Region might want to explain what actions the Government is planning in this area and what the Bank can do to provide support.

* Monopsonistic marketing structures. The Polish economy is highly monopolized, rigid and subject to restrictive practices. The liberalized imports regime and the easier access to foreign exchange will help to make the domestic manufacturing and distribution enterprises more efficient and market responsive, but without increased domestic competition, the real benefits of liberalization will be elusive. There are indications that, for example, the overwhelmingly private agricultural sector has been slow to respond to higher prices because of the monopsonistic marketing structure. The Region might want to discuss what specific actions are considered for fostering domestic competition under the SAL.

where is the supply response coming from

* Conditionality in the environmental area. The environmental problems in Poland are severe--and well documented. The IM proposes to include specific environmental measures in the SAL policy matrix. The measures under consideration are: changing the incentive structure (fees, fines and taxes), revising emission and effluent standards, introducing a negotiating process for phased implementation of the new standards, and incorporating environmental considerations in the restructuring or privatization of enterprises. Given the managerial weaknesses in Polish enterprises and the extreme turbulence in the economic situation, there is a significant risk that the proposed environmental actions will result in administrative overload and, thus, slow down and complicate the restructuring of the enterprise sector. The Committee might want to consider the merits of including the environmental measures or waiting until a future operation when the economic reform program is well under way.

flexibility for
to whom, in
what way

* Flexibility in SAL implementation. In Mr. Lari's covering memorandum, the Region points out the need for more than usual flexibility in light of the great uncertainties involved in the Polish reform program. The Committee might want to discuss if greater flexibility is warranted and the most appropriate way of reflecting this in the loan conditions.

* Potential failure of the stabilization program. The IM describes the close linkages between the stabilization program and the envisaged structural transformation of the economy. Thus, it concludes that changes should be introduced rapidly and simultaneously at both the macro and micro levels. In Mr. Lari's covering memorandum, the Region raises the question of how to respond if the Fund's standby arrangement run into problems. It suggests that, in a "worst case scenario", the Bank might fall back on project or hybrid lending to support the reform program. Given the uncertainties surrounding the effects of the stabilization program (for example, the January inflation rate is reported to have increased to 68 percent compared to the Fund target of 45 percent), the Region might want to explain what would trigger a change in lending approach. The Committee might also want to consider if project lending would be an appropriate response in case the economy failed to stabilize.

What would trigger a change

* Loan amount and financing plan. The IM identifies a financing gap of US$13.2 billion for the 1990-92 period, of which US$7.4 billion would come from normal rescheduling and US$5.8 billion from permanent debt relief. Since Paris Club creditors hold about two-thirds of Poland's convertible currency debt, this presumably would involve an exceptional reduction of official debt or debt service. The Region might want to discuss the likelihood of such relief and the possible impact on the program in case it does not materialize. The Polish Government is interested in increasing the loan amount from the proposed US$300 million to US$500 million. In Mr. Lari's covering memorandum, the Region argues that such an increase would not have a material impact on the financing gap but that it would contribute to a rapid increase in Bank exposure. What guidance does the Committee want to provide regarding the loan amount?

No

OC Members

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Wapenhans, Rajagopalan/Fischer, Shihata, Kashiwaya, Wood, Vergin.

cc: Messrs. Lee (COD); Shakow (SPR); Holsen (CEC); Rao (FRS); Bock (CFS); Picciotto (PBD); Burmester/Thahane (SECGE); Goldberg (LEGOP); (Ms.) Iweala, OPNSV; Thalwitz (PPRSV); Parmar (IFC-CIO); Linn (IEC); Kavalsky (FRM); Pfeffermann (IFC-CEI); Liebenthal (SPRPA); Kilby (FRS); Robless (OPNSV); (Ms.) Haug, Khanna (EXC); Lari, Thumm, Nouvel, Lav, (Ms.) Loos (EMN).

PLjung

→ Squeeze thru credit allocation – not efficient
liberalize the system.
Enterprises should bid + be liquidated

Liberalization vs stabilization
Raising prices is not liberalization – they
did not free the system

They look at Year to Year figures 18 1/2 %

Some real rigidity has come back to the system

We are not E. Europe

No Change in overall strategy re getting
export Coastal regions to pull rest of the economy
Going to take
Take next steps towards liberalization
Investment activity diminishing –

People frightened

1. Regional loan boards can influence on the credit allocation system
2. Would not speed up the program -

3. Funds not open to expansion.

4. Need for opening up - Do not seem to want to liberalize -

5. Chinese so far, that it will Expand as soon as we give them a little string

February 7, 1990

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1.

THE WORLD BANK
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee to Consider
YUGOSLAVIA - Second Structural Adjustment Loan (SAL II)
Green Cover Package

Held on Wednesday, February 7, 1990, at 3:00 P.M. in Room E1243

A. Present

Committee

Messrs: M. Qureshi, Chairman
H. N. Scott, LEGVP
D.J. Wood, FPRVP
S. Fischer, DECVP
K. Kashiwaya, CFSVP
R.J. Cheetham, ASIVP
N.D. Roger, LACVP
E.V.K. Jaycox, AFRVP
W.A. Wapenhans, EMNVP

Others

Messrs./Mmes. E.F. Lari, EM4DR
V. Dubey, EAS
D. Lee, CODDR
P. Hasan, EMNVP
U. Thumm, EM4DR
B. Santos, LEGEM
N. Okonjo-Iweala, OPNSV
P. Nouvel, EM4CO
A. El Maaroufi, EMNVP
R. Myers, EM4CO
A. Kanaan, EM4CO
S. El Serafy, EAS
C.F. Obidegwu, SPRPA
A. Lahiri, IMF
G. Oliveros, FRS

B. Issues

1. The Operations Committee met on February 7, 1990, to discuss the Green Cover Package for the Second Structural Adjustment Loan (SAL II) to Yugoslavia in the amount of $300 million. Because a similar package had been distributed and an Agenda circulated in July 1989, an Agenda was not prepared by the Economic Advisory Staff. Instead, the Chairman and other speakers highlighted five main issues. Three of these issues related to differences between this and the previous package and included, how the IMF program had been strengthened, the greater focus in this package on enterprise reform and the consequences of adjustment and the near completion of the liberalization program. A fourth concerned the macroeconomic framework for SAL II, while the final issue concerned the size and traching of the loan.

C. Discussion

2. The Region introduced the proposed loan by stating that now was the propitious time to move on the operation. Several political and economic developments in Yugoslavia were positive while the negative elements, mainly relating to ethnic friction and the threat of dissolution, were old, familiar ones unlikely to get out of Government control. The new Prime Minister, Mr. Markovic, was a serious reformer with a good program who had consolidated his position. The increased plurality of political views, a positive thing, was not matched by differences of opinion regarding economic reform. Instead, Mr. Markovic's views dominated throughout Yugoslavia. It was noted that the Invitation to Negotiate the loan would be held up pending notification to the OPNSV that agreement on an IMF Standby had been reached. However, the Region noted that such a Notice could come very quickly, perhaps as early as the beginning of the week of February 12th, given the progress and timing expected by the IMF mission currently in Belgrade. The Chairman followed this opening statement by indicating that Mr. Conable and he had, two days previously, met with Mr. Markovic and they were similarly impressed by his assertiveness, borne from a sense of security, and his determination to carry out the IMF Standby and the SAL II and other proposed IBRD adjustment programs. His attitude was relatively relaxed about inter-regional friction and buoyed by the realization that there was really no alternative, opposing view to his reform program.

3. The discussion regarding the IMF's program recognized that the addition of fiscal coverage of enterprise deficits should markedly enhance the programs's anti-inflationary impact. Instead, questions by several members focused on the second issue, specifically on the apparent vagueness in the programs supported by SAL II for reforming enterprises and for mitigating for the social consequences of adjustment. The Region responded regarding enterprise reform that, <u>legislation</u> enabling/encouraging the emergence of reformed enterprises, <u>new institution(s)</u> to foster/support enterprise reform and specific, implementable <u>programs</u> for the reform of some of the enterprises were the focus of second tranche release conditions. In addition, regarding implementation of programs, the Region now feels that at negotiations the current focus of the second tranche condition on 5 out of 20 enterprises might be changed so that about 50% of losses are covered. Concerning programs for the social consequences of adjustment, initial success had been achieved by getting the Government to finance the <u>recurrent costs</u> of caring for an estimated increase in unemployment of 200,000 workers in 1990. However, programs and financing for covering the <u>capital elements</u> of labor force adjustment, particularly job information systems, retraining programs and new investments, were still being developed. Overlapping both of these areas are second tranche conditions regarding programs to encourage and finance SME's. These are strongly endorsed by the Government, but are still at an early stage of formulation. A general consensus emerged in the meeting that the crucial nature of these second tranche conditions warranted more detail in the policy matrix (pp. 29 and 30 of the PR). For example, the matrix might spell out in more detail the expected essence of new legislation, institutions and programs. Also, the criteria to be used to evaluate them should be summarized. It was noted that, with a few exceptions, such detail was present in the text and the Guarantee Agreement of the Green Cover package.

4. The discussion then shifted to the capability of Yugoslavia to carry out new reforms in the enterprise and banking sectors and to the appropriateness of the sequencing of the reforms. The Region responded regarding the first that several developments, one too recent to be included in this draft of the PR, led them to be quite encouraged about implementation issues. The Government was currently engaged in altering the monopoly status of SDK, the country's only accounting and auditing organization, so that external expertise could be brought in to perform the audits on banks and enterprises. Furthermore, the Government had now dropped a long standing prohibition against borrowing abroad to finance technical expertise and was, in fact, seeking such finance from IBRD and others. On the basis of this, and the fact that the first $1.5 million had already been provided by the Government in its budget, the Region now has less concern regarding the Government's ability to implement the program. It was recognized that certain sequencing issues might have arisen had the Government not already virtually completed its liberalization measures. In this case, however, it was felt that the success of the program over the longer run will be affected less by too early liberalization per se and much more by the speed and effectiveness of the enterprise and banking reforms. In other words, the liberalizations are now a fact, and the reform focus must shift to the enterprises and banks.

5. The discussion on the macroeconomic program centered on the appropriateness or otherwise of the generally bleak projections. The Chairman stated that the scenario projected was not a viable growth scenario unless the country could attract private investment. Given this, incentives are very important both to attract private investment and improve efficiency. Similarly, the official debt strategy was conservative in the sense that total external indebtedness was projected to change little, in fact, fall slightly. The response to these points by the Region and others was that the scenario was a generally, "wait and see" one which recognized that the potential impact on the economy of the extensive reforms would not be all positive. In essence, a sustained growth of 3% per year without additional net foreign borrowing and with the national savings rates which were projected, was a difficult but achievable performance given the expected reforms. However, it was noted that if the reform progressed fairly rapidly, and was accompanied by, among other things, reliance on private foreign capital (something the Government encourages), Yugoslavia would have greater flexibility to borrow more from abroad in the future.

6. The fact that so many of the conditions for Board presentation had been or were being met and the importance of the second tranche conditions to the success of Yugoslavia's reform effort, led to a suggestion that the tranching of the loan be somewhat back-loaded. This view was generally shared in the Meeting. The Region expressed the opinion that in such a case a somewhat larger amount than $300 million might be warranted. There could be a potentially quite large jump in imports associated with the liberalization and stabilization programs and with the subsequent reforms in the enterprise and banking sector. In addition, country expectations regarding the extent of adjustments already taken and agreed to had led to a request for a larger loan amount.

D. Conclusion

7. The Region was authorized to proceed to invite for negotiations, subject to notification to the OPNSV that the IMF Standby was proceeding on track. The Chairman stressed that special attention should be paid to several points raised during the discussions, especially those relating to enterprise reform and to elaboration of programs for the social consequences of adjustment. Regarding the loan amount and tranching, he said he was prepared to consider an increase in the loan size to $400 million, to be tranched at $150 million and $250 million respectively. The increase should be considered as a reduction in other, preferably adjustment, lending rather than as an increase in the size of the Yugoslavia lending program. This latter decision would be subject to approval by Mr. Conable.

RMyers:c:vl
2/14/90

The World Bank
OPERATIONS COMMITTEE

CONFIDENTIAL

Minutes of the Operations Committee to Consider
YUGOSLAVIA - SAL II - Initiating Memorandum

Held on Friday, June 17, 1988 at 10:00 a.m. in Conference Room E-1243

A. Present

Committee		Others	
Messrs.	M. Qureshi (Chairman)	Messrs.	T. Baudon (SVPOP)
	J. Burki (ASIVP)		V. Dubey (EAS)
	A. Choksi (LACVP)		A. El Maaroufi (EMNVP)
	S. Fischer (VPDEC)		J. Harrison (EM4CO)
	H. Scott (VPLEG)		P. Hasan (EMNVP)
	I. Serageldin (AFRVP)		E. Lari (EM4DR)
	W. Thalwitz (EMNVP)		S. Mitra (FRS)
	H. Vergin (SVPOP)		R. Myers (EM4CO)
	D.J. Wood (VPFPR)		P. Nouvel (EM4CO)
			G. Pohl (EAS)
			G. Reif (SPRPA)
			K. Siraj (COD)
			A. Sood (EM4IE)
			T. Thahane (SEC)

B. Issues

1. An Operations Committee Meeting was held on Friday, June 17, at 10:00 a.m. to consider the Yugoslavia Initiating Memorandum for SAL II. The meeting followed the Agenda questions, focussing particularly on stabilization and enterprise reform and on the credibility of the present reform effort. In its opening statement, the Region stressed that there were reasons to believe that this time the Government of Yugoslavia was serious about reform. These included less ideological and more pragmatic attitudes, a general perception of the seriousness of the country's economic problems, the discredit in which the current system had fallen, strong political pressures to introduce radical systemic changes, pervasive modifications already introduced or being introduced in the legal framework, the reform trend in the external environment, the strong desire to associate if not integrate Yugoslavia in the EC, and the front-loaded nature of the reforms. Changes had already been introduced in many areas such as financial discipline, interest rates and foreign exchange allocation. Significant additional reforms were likely to take place in the fiscal

system and there were constitutional amendments under consideration which would affect the nature and the goals of enterprises and banks. He concluded, however, recognizing the substantial risk element of the proposed operation.

2. The Chairman noted that in the past Yugoslavia had followed a cyclical patterns of reform and backsliding so that it never seemed to make any real progress in reforming the economy. The Region emphasized the new and pervasive outward orientation of Yugoslavians, particularly due to returned guest workers, and an intense desire to harmonize with the EC, and to become more clearly a European economy. Furthermore, this time the pressure to reform comes not only from the Federal Government but also from the Republics and Provinces. However, it should be recognized that the proposed SAL II could not alone support all the changes needed to affect the real economy. Other operations would also be needed. Several other members of the Operations Committee, while expressing doubts about the seriousness of Yugoslavia's reform intentions and/or ability, were inclined to take the view that the risks associated with this loan were worth taking, given the likely beneficial impact that such support would have on the country's reform effort.

3. A member then raised specific questions about the stabilization program. The thrust of his comments was that the fiscal and monetary policy measures to stabilize the economy were not clear. The representative of the IMF described the variety of measures included in the recently agreed IMF Standby. Due to the complexity of the Yugoslavian economy, she noted that a broad brush approach was needed. Therefore, the program included measures of monetary and fiscal policy, incomes policy and interest rate and exchange rate policy, as well as institutional reform. The member was only partially convinced and stressed that making the National Bank of Yugoslavia (NBY) a more effective central bank was a necessary important first step. He also noted that a policy of fixing the real interest rate, even at a positive level, does not necessarily reduce the inflation rate. There was a general concern that as in the past when the adjustment measures started to bite enterprises would find ways and means to avoid the consequences. It was important to ensure that the adjustment process was not aborted in this fashion. Conditionalilty, therefore, needed to be designed and monitoring mechanisms put in place to prevent this happening.

4. The focus of the meeting then shifted to the questions on the proposed reform in the areas of foreign exchange allocation and trade and price liberalization. The Region stated that given the way the interbank meetings are structured, and the enhanced role of NBY as a central bank, it would be difficult for the Government and enterprises to interfere with foreign exchange allocation directly. In monitoring the market, the Bank intended to look at both macro and micro indicators. Macro indicators would involve comparing the volumes of foreign exchange to demand and supply, the size of the gaps and the extent of the exchange rate movement. At the micro level the aim was to analyze developments in selected enterprises to see if enterprises encounter any artificial restrictions on the demand for and supply of

foreign exchange. It was noted that at present, the market seemed to be working well. Because of the high interest rates people were most concerned about obtaining Dinar coverage for foreign exchange - a good sign. Regarding trade liberalization, the Region acknowledged that actually measuring liberalization is extremely difficult but that if the projections of total imports are accurate, the liberalization should be substantial unless the composition of trade shifts dramatically. It stressed, however, that the most important thing to realize about the reform effort is the Yugoslavians' desire to liberalize in order to be compatible with GATT and the EC.

5. Regarding price liberalization, the Region stated that decontrol of 80% of prices is significant. Decontrol is also intended to apply to items in the retail price index. In addition, it was expected that the Government would agree to adjust prices of major infrastructural services (railways, energy) so that real prices reach appropriate levels. The Chairman stressed, that if possible, we should try to get the Government to agree to push reforms, particularly price liberalization, even faster than proposed. In addition, he noted the importance of SAL II's proposals with respect to investment allocation and the social cost of adjustment. The Region added that those relating to the social cost of adjustment were crucial and, in fact, were a constituent part of the reform effort which the Bank should be ready to support. The Chairman agreed and added that encouraging SSI's was an important element in this.

6. Additional comments concerned the need for a clearer financing plan and for an early Country Strategy Paper (CSP).

C. <u>Conclusion</u>

7. In conclusion, the Chairman approved the departure of the appraisal mission. He said he did not consider that a larger loan amount was justified. He instructed the appraisal mission to deepen and spell out in greater detail the medium-term macroeconomic stabilization policies, discuss them carefully with the IMF colleagues, and review them with the PPR. It is also important to establish effective monitoring mechanisms. In addition, a clearer picture of the financing plan was indeed needed, with the roles of the different sources of finance spelled out, and a CSP should be prepared within six months.

Amended: June 27, 1988

PNouvel/VDubey:pl

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: January 31, 1990

TO: Mr. Moeen Qureshi, OPNSV

FROM: W.A. Wapenhans, EMNVP

WA

EXTENSION: 32676

SUBJECT: YUGOSLAVIA: Proposed $300 million Second Structural Adjustment Loan (SAL II) - Green Cover Package

1. Attached please find, for your approval, the Green Cover package for the above-mentioned loan, submitted under cover of a memorandum from Mr. Lari, which I endorse. A draft Notice of Invitation to Negotiate the proposed loan is also attached for circulation to the Executive Directors. The actual Notice and the Invitation to Negotiate will only be issued once we have had occasion to review the findings of the IMF mission and are certain that the Program remains on track.

2. Subject to your approval of the package, we intend to distribute it to the Operations Committee this week. This timing would allow us to have an OC meeting, if necessary, in mid-February and to negotiate toward the end of February (assuming approval is given), in line with the strong wishes of the Prime Minister. As of now, the IMF staff hopes to present the proposed new Standby to the Fund Board at the end of February. We would like to move in parallel and present the proposed SAL II to the Bank Executive Directors by mid-March.

Attachments

Distribution:

Members of the Operations Committee:

Messrs. Qureshi (OPNSV)(o/r); Karaosmanoglu (ASIVP); Husain (LACVP); Jaycox (AFRVP); Wapenhans (EMNVP); Fischer (DECVP); Shihata (LEGVP); Wood (FPRVP); Rajagopalan (PREVP); Vergin (OPNSV)

cc: Messrs/Mmes: Stern (SVPFI)(2); Thalwitz (SVPPR); Kashiwaya (CFSVP); Frank (CFPVP); Parmar (CIOVP); El Rifai (MIGPA); Thahane (SEC); Lee (COD); Dubey (EAS)(2); Bock (CFS); Shakow (SPR)(2); Holsen (CEC)(3); Linn (IEC); Churchill (IEN); Hamilton (PHR); Pouliquen (INU); Petit (AGR); Piddington (ENV); Rao (FRS); Gustafson (CEMDR)(3); Hassan, Santos (LEG); Mills (LOA); Hasan, El Maaroufi (EMNVP); Lari, Thumm, Zaidan (EM4DR); Nouvel, Kanaan, Myers, Farsad, Ding, Matic, Bacon, Narain (EM4CO); Apitz (EM4IN)(2); Ramasubbu (EM4AG)(2); Sood (EM4IE)(2); Bouhaouala, Blanchi, Hinds,(2), Al Kafaji, Baudon, Harbison, Roa (EMT); van Houten (IMF)(3); EMENA Information Center (3).

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: January 31, 1990

TO: Mr. W. A. Wapenhans, EMNVP

FROM: Eugenio F. Lari, Director, EM4DR

EXTENSION: 32552

SUBJECT: YUGOSLAVIA: Proposed $300 million Second Structural Adjustment Loan (SAL II) - Green Cover Package

1. Attached please find the draft President's Report (which includes the Government's draft Letter of Development Policy (LDP) as Appendix II), the draft Loan and Guarantee Agreements, and a draft Notice of Invitation to Negotiate. These documents are based on the findings of the appraisal mission of September 1988 and further discussions during follow-up missions, most recently in December 1989. A transmittal memorandum to the Senior Vice President-Operations is also attached for your approval subject to your endorsement of the package. The package has been cleared by the concerned Departments.

Background

2. As you know, SAL II has been in the formulation process for over three years, following a mixed experience with the first SAL (FY83). Although SAL I was disbursed and succeeded in strengthening exports, compliance with the policy conditions could be characterized as stop-go in the initial phase, and by considerable backsliding in the period after the loan was fully disbursed. We have therefore been careful to link finalization of SAL II to convincing evidence of actual policy progress and seriousness of purpose to continue and further develop the reforms. I believe that the evidence is now there and that we should move this proposed operation forward at this time.

3. More specifically, the Government has now adopted a far-reaching stabilization and structural adjustment program with a good chance of success. We, the Government and the IMF have worked closely on the program, which we endorse. Mr. Markovic, the prime minister, submitted the entire package of laws and measures simultaneously to the Federal and Republic Assemblies and, although there was some vocal opposition, the program was accepted, with certain reservations, at the end of December, 1989. A follow-up IMF mission will go to Yugoslavia shortly and it is expected that problems arising from these reservations will be worked out by the time of the mission's return, scheduled for the end of the week of February 5th.

Distribution: Messrs./Mmes. Hasan, El Maaroufi (EMNVP); Kopp (EM1DR); Dervis (EM2DR); Stoutjesdijk (EM3DR); Lari, Zaidan, Thumm (EM4DR); Bouhaouala (EMTDR); Hinds (EMTTF); Blanchi (EMTAG); Al Khafaji (EMTIN); Harbison (EMTPH); Baudon (EMTEN); Roa (EMTPR); Santos (LEGEM); Mills (LOA); Nouvel, Kanaan, Myers, Farsad, Ding, Matic, Bacon, Narain (EM4CO); Apitz (EM4IN); Sood (EM4IE); Ramasubbu (EM4AG); Emena Information Center.

There are of course risks that it be weakly implemented, delayed, or even revers
However, these risks now appear reduced and acceptable, notwithstanding the sho
term political uncertainties, given the present reform climate in Yugoslavia as well as in neighboring Eastern Europe.

4. The compatibility of the IMF and SAL II programs leads us to propose that they be processed together and, therefore, to distribute the SAL documents to the Board when the Fund staff have distributed the Standby documents to their Board, now expected to be end-February 1990. In order to meet this timing we seek authorization from the Operations Committee to invite negotiations but we will delay extending the invitation until after the IMF agreement is finalized. We will inform the Operations Committee by memo of the timing and content of the final IMF agreement and of our intention to invite the Government to negotiate.

The Political Setting

5. The centerpiece of the platform of the new Federal Executive Council (Cabinet) is the implementation of the economic reforms and the program of disinflation as agreed with the IMF. The program was approved by the Federal and RAP assemblies although the latter had some reservations which will require some adjustments to the program (para. 14). The Prime Minister, Mr. Markovic, has gone out of his way to emphasize the importance of this program as well as his determination to implement it. A successful industrial manager from Croatia, he has streamlined the Cabinet and obtained a greater degree of executive powers for it.

6. Our positive view regarding the adoption and implementation of the program results from a perceptibly changed political and economic climate in Yugoslavia. Although events in Eastern Europe have influenced this climate, the main reason a better reform atmosphere predates these developments and results from several years of economic stagnation or decline, rising unemployment, and a skeptical stance by foreign lenders--plus the explosion in the rate of inflation. This seems to have convinced the Yugoslavs that economic prospects are bleak in the absence of fundamental reforms and resulted in an agreement by all parties on the general thrust of necessary economic reforms.

The Economic Setting

7. Spiraling inflation--reaching 58% in the month of December 1989--and prolonged stagnation of GDP have led to a major re-evaluation of past stabilization and adjustment programs by Yugoslavia. Intensive discussions among the staffs of the IMF and the Bank and several joint missions to Yugoslavia have led to formulation of a medium term program for suppressing inflation and reattaining positive growth rates of GDP. The initial phase of the program is the simultaneous adoption in early 1990 of a new stabilization program supported by the IMF and an adjustment program supported by the SAL II. The essence of these programs is set out below and in paras. 19-24 and 29-63 of the President's Report. Crucial to the success of the initial phases of both these programs are recently taken legislative actions and Government acceptance of the need for their prompt and full implementation, continued liberalization of prices, trade, and foreign exchange allocation, accompanied by thorough reforms of the banking and enterprise sectors. These reforms would initially be supported by SAL II and by the Standby. Later, in early FY91, a Financial and Enterprise Structural Adjustment Loan (FSAL) would provide continuing support for financial and enterprise sector reforms. In addition, the initial work on proposed Bank adjustment operations for fiscal re

and a more traditional operation for strengthening SME's in Yugoslavia have already begun.

8. The approach to stabilization and adjustment which forms the essence of SAL II and the new IMF Standby is based on a consensus between the Bank, IMF and Government that enterprise deficits - usually recurrent losses - have been the root cause in recent years of both the inflation and the lack of GDP growth. It has been the financing of these deficits by inflationary means--via banks and excessive money creation--which has led to spiraling inflation. The same deficits reflect the inefficient use of capital stock and have led in recent years to a decline in investment relative to consumption, which was stimulated mainly by paying wages in excess of labor productivity.

The Economic Policy Program

9. The most recent articulation of the Government's Economic Policy (Reform) Program is reflected in the LDP (Appendix II of the President's Report). The main objective of this program is to bring about a comprehensive restructuring of the Yugoslav economy to base it on free market principles and to integrate it into the world economy. The Program has been embodied in a comprehensive set of laws and regulations that have either been approved or are expected to be approved shortly. The manner in which the most important of these laws is expected to improve economic performance and help control inflation is detailed in the President's Report (paras. 45, 53-54). The specific measures of this Program to be supported by the proposed loan, including conditions of tranche release, are also detailed in the PR (paras. 28, 31, 36, 40-41, 46, 51, 58, 63) and Table 4--The Policy Matrix). In this memo I would like to focus more specifically on the new elements which have been added to the program.

Is this enough?

10. The heart of the new program consists of six main elements: (i) replacing inflation tax transfers with fiscal transfers; (ii) financial system reform to strengthen financial discipline via stiffer application of the Law on Rehabilitation and Bankruptcy (LRB) to the enterprise sector; (iii) reform of the enterprise sector as driven by pressures from the Federal and RAP governments (for very large enterprises) and by stiffer application of LRB by banks for all others; (iv) more effective financing of and programs for alleviating the social costs of adjustment for increased unemployment; (v) liberalizations of the trade, price, and foreign exchange regimes to improve the workings of markets and competition; and (vi) adoption of stringent demand management programs in an IMF Standby setting.

11. The first four of these six constitute the new approach adopted in the reform program. A few large enterprises account for most of the deficits, but experience elsewhere suggests a high risk that these enterprises would, in fact, be immune to the application of LRB even by a reformed financial system. In the new program, their deficits would be covered by revenue flows through budgets of the Federal and Republican Governments, who would also accept responsibility for pushing the reforms needed to eliminate these enterprises' deficits. Removing the burden of these large deficit enterprises from the banking system will enable financial reform and permit strengthened banking system enforcement of the LRB for the remainder of the enterprise sector. The primary social cost of adjustment will be, initially, a decline of about 1.5% in GDP in 1990. More fundamentally, an increase in unemployment of about 200,000 is expected in 1990 as the process of enterprise reforms begins to bite. This may well rise further in subsequent years.

12. New Federal and Republic expenditures to finance this program for 1990 are estimated to require about 5% of GDP, all of which would be made available in 19 This tentative estimate is for the financing of the largest enterprise deficits, strengthening of the income prospects of the financial system and financing the expected additional social costs of adjustment. The Federal and Republican budgets for 1990 include provisions for financing this estimated adjustment cost of 5% of GDP by new taxes and improved tax collection. The financial cost of 5 percentage points of GDP is based on a careful budgeting exercise undertaken with IMF assistance. The financing figure as a percent of GDP originally appeared to be higher, but removal of some double counting plus expectations of lower enterprise deficits through stricter control on wage payouts has brought it down to 5%. However, should the cost, within the context of an overall balanced budget, be higher than estimated, additional measures would be introduced at the time of the mid-term review (Standby) or second Tranche release (SAL II). It is this fiscal approach to covering losses formerly financed through the banking system which causes us to believe that this time the IMF program will succeed in dramatically lowering inflation.

The New IMF Standby Arrangement (SA)

13. The December Fund mission reached an understanding with the Government of Yugoslavia on a rapid "disinflation" program which they propose to present for IMF Executive Board consideration at the end of February, 1990. This date is contingent upon Federal and Republic assembly approval of a program in its entirety. As noted, the program approved on December 18, 1989, contained certain RAP Assembly reservations. These require a short IMF follow-up mission, planned for early February, which will rework the quantitative targets and negotiate a new tax package acceptable to the RAPS. It is expected that the Standby will be for 18 months i amount equivalent to at least SDR 460 million, or 50% per annum of quota. Quantitative targets for the first two quarters of 1990 will be re-established but those for end-September and end-December 1990 will be indicative and will be finalized during the end-June 1990, mid-term review.

14. The policy program expected to be supported by the Standby (paras. 19-24 of the PR) would cover measures in the areas of monetary, fiscal and incomes policies, financial discipline applied to banks and enterprises, and trade and foreign exchange policies. The program is a strong one with a good chance of success. The program aims for a dramatic drop in the rate of inflation from current levels of about 50% per month to an average of 1% per month by March-April 1990. The exchange rate for a new Dinar has been pegged to the German Mark at Din. 7 per DM. Nominal wage levels have been frozen at their November levels while many prices were allowed to rise. This will allow some reduction of enterprise deficits. Although the December 1989 IMF mission reached an understanding with the Prime Minister, it was agreed that more revisions to the program would be needed should the December 31-January 31 inflation rate be excessive, which it was. In addition, some of the RAP Assemblies approved an altered program which allowed for some unplanned wage increase and omitted some revenue increasing measures needed to finance enterprise deficits. As a result, an IMF "mini mission", planned for early February, will likely revise the program so that all prices are frozen and new revenue measures to replace those not approved by the RAP Assemblies enacted.

The Proposed SAL II and the Bank's Assistance Strategy

15. Actions Already Taken During SAL II Preparation: Among the most important are: (i) establishment of interbank foreign exchange and money markets, with the former being open to individuals, so that the exchange and interest rates are adjusted periodically to reflect changes in demand/supply conditions; (ii) increase in the (import weighted) share of imports under the totally free trade regime from 11% in December 1987 to 85% in December 1989; (iii) increase in the share (weighted by the producer price index) of freely-formed prices from 27% in December 1987 to 75% in June 1989; (iv) establishment of real interest rates of at least 5%; (v) strengthening the law on rehabilitation and bankruptcy by increasing its coverage and tightening income restrictions on illiquid and loss-making firms, with the result that a greater, yet still small, number of loss-making enterprises are being affected; (vi) strengthened accounting and auditing regulations, procedures and enforcement standards; (vii) wide application of the uniform methodology for investment evaluation, developed with Bank assistance; and (viii) standardization of country-wide solutions to alleviate the social costs of adjustment and provision of fiscal financing for the social costs of up to 200,000 unemployed.

16. Core Second Tranche Conditions for SAL II (see the policy matrix in the PR table 4) relate to developments in the macro framework, formulation and initial implementation of programs for enterprise and banking reform, and for stimulating SMEs and for alleviating the social costs of adjustment. In the area of enterprise reform, the focus of these second tranche conditions is on establishing legal and institutional arrangements, with well-defined phase-out provisions, for the rehabilitation of large, seriously inefficient enterprises. Evidence of operation of the programs would be the initiation of implementation of rehabilitation programs for at least five such enterprises. Regarding banking reform, the primary focus is on development of supervisory, regulatory, and auditing functions (probably in NBY) and on establishment and initial implementation of appropriate institutions and procedures for restructuring the banks. Given the Government's strong commitment to the development of SMEs, we would expect by second tranche release to have evidence that a coherent program for, "leveling the field" exists and is being implemented so that ease of entry is guaranteed. Thus, for example, we would expect equal tax treatment and similar education and health assessments for all enterprises regardless of structure and freedom for SMEs to find alternative, cheaper ways to perform the functions now performed by law by SDK--the State accounting monopoly. Regarding the social costs of adjustment, we expect by second tranche release that the current, somewhat bolstered programs, which are mainly redistributional in nature, will be supplemented by retraining and other programs which will upgrade and modernize the expertise of the labor force.

17. The thrust of the Bank's assistance strategy to Yugoslavia, as approved by Senior Management, is to support the country's economic reform program over the long haul. This is to be done through a higher level of assistance than in the last five years that would include a series of policy-based operations as well as sector investment and project loans. The series of policy loans, starting with SAL II, would support priority areas of the reform. Thus, SAL II is expected to be followed by an FSAL (FY91) that would deepen the Bank's assistance to Yugoslavia's financial and enterprise restructuring which is being started under SAL II. The proposed third SAL (FY91/92), in turn, is likely to support the reform of Yugoslavia's fiscal system. More traditional investment projects to support SMEs and facilitate enterprise restructuring are also being proposed. At present we are working on a lending program of about $1.5 billion for FY91-93, although we could

deliver a much higher program of the order of $2-2.5 billion, if Yugoslavia's economic performance, project preparation, and coordination among Republics were to improve.

IBRD Exposure

18. In autumn 1988, Yugoslavia signed a rescheduling agreement with the Paris Club and a refinancing and new money package with its commercial creditors which included a 5 year grace period. The Paris Club is expected to consider further rescheduling requests after the Standby is approved in early 1990. As a result, and in view of the fact that current net disbursements are negative, even with a series of fast-disbursing adjustment loans, the Bank's exposure in Yugoslavia would not increase significantly above its current level of about 15 percent (see President's Report, Table 3).

Downside Risks

19. There are several risks that could inhibit the effectiveness of the reform and, therefore, of the proposed loan. The most significant include: (i) a sluggish supply response and, therefore, a continuation of the stagnant growth of the past couple of years; (ii) the current high inflation does not respond to the stabilization program, as was the case under the 1988 Standby Arrangement; (iii) the social costs of adjustment (primarily increased unemployment and lower real wages/incomes) are significantly higher than expected.

20. A combination of these three related economic risks would call the credibility of the whole program and the Government into question and significant policy backsliding would become quite likely. In particular, the restructuring of the enterprise sector to improve its efficiency and deal with the large loss-makers would probably be decelerated, or even thwarted. These risks are real, but we believe that the IMF's Standby and the adjustment measures to be agreed under this proposed SAL II loan should together effectively reduce inflation while markedly improving growth performance in the medium term. In addition, there are several monitoring devices which will enable us to delay Board presentation, currently scheduled for mid-March, and/or second tranche release if the risks of the operation increases unacceptably. The first would be the inability to agree at SAL II negotiations on specifics relating to second tranche release conditions. A second would be the IMF's refusal to submit the program to its Board for approval. This would occur if the revisions expected in late January are not approved by the RAP Governments. Further, the IMF's mid-term review, expected to take place in end-June 1990 under the standby and our second tranche review, likely to occur during the summer of 1990, would indicate the extent to which adjustment, appropriate for the release of the second tranche has occurred. Release of the second tranche of the proposed SAL II would be conditional upon, inter alia, a review of macroeconomic performance and progress in the implementation of the adjustment measures. The social costs of adjustment would also be monitored closely by the Yugoslav working group established for the purpose and agreement on measures to deal with such costs is a condition of second tranche release. In conclusion, the economic risks are significant given the high inflationary expectations, the considerable regional disparities and the fact that the structure of the whole economy is in flux, but we believe that the care taken in the design of the proposed SAL and Fund Standby mitigates them and, therefore, that they are worth taking.

21. While risks due to political tensions cannot be discounted, they should not be unduly exaggerated. Ethnic tensions have been and continue to be quite high, particularly with regard to Serbia's relations with Slovenia and Kosovo. However, while the various parts of the Federation may not feel the same degree of national commitment as others, on balance, without excluding the probability of certain changes in the rules governing the Yugoslavian Federation, there is no credible alternative at present than for the country to continue to remain a unitary economic entity. In this context, a successful reform effort would augment political stability and reduce to some extent political/ethnic tensions.

Conclusion

22. Although we propose to delay the extension of the invitation to negotiate until an appropriate IMF program is finalized, and will inform the OC accordingly, we feel that now is the appropriate time to request authority to extend the invitation to negotiate. In view of: (i) the remarkable progress to date in laying the legal foundation for a fundamental transformation of the basic structure of the Yugoslav economy; (ii) the strong commitment and claim of ownership that the Markovic Government has made with regard to the reform program and the support this program seems to enjoy with the majority of the population; (iii) the measures already implemented in the fields of: the foreign exchange system, trade and price liberalization, interest rate policy, credit controls, wage controls, limits on public spending, banking and enterprise reform, and investment evaluation; (iv) the strong measures expected to be implemented under the proposed SAL II, as tranche release conditions; and (v) the expectation that the IMF would continue its active presence in Yugoslavia; I believe that the proposed loan is now justified and would substantially contribute to the success of the economic reform in Yugoslavia and the Government which promotes it. Conversely, if the reform does not receive at this politically crucial juncture sufficient support from Yugoslavia's development partners, it may be seriously compromised, with probably very negative consequences for the well-being of the society and, ultimately, the integrity and stability of the country, as well as for the Yugoslav-Bank relations.

Processing Schedule

23. If you agree, the following schedule would apply.

Package to OPNSV	Early February
OC Meeting (if necessary)	Mid-February
Start Negotiations	February 19
Board Presentation	March 20

Attachments

RMyers:pk/bhn

February 5, 1990

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

900R01003

1.

DATE: January 31, 1990

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

Dubey

EXTENSION: 78051

SUBJECT: HUNGARY - Structural Adjustment Loan Initiating Memorandum; Operations Committee Meeting Agenda

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1. The Operations Committee will meet on **Monday, February 5, 1990, at 12:00 noon in Room E1243** to consider the Hungary Structural Adjustment Loan Initiating Memorandum in the amount US $200 million equivalent. The following represents a proposed agenda for the meeting.

Background

2. For the past 20 years, Hungary has been at the forefront of economic reforms among socialist countries. However, the effects of these piecemeal reforms of the orthodox central planning system have been rather disappointing. During the 1970s, investment and some growth were maintained by heavy external borrowing. During the 1980s, access to external borrowing was limited and growth averaged just above 1% p. a. Today, Hungary is one of the most heavily indebted economies, with a debt-to-GNP ratio of 74% (compared to 60% for the 17 most highly-indebted middle income countries) and a debt service ratio of close to 50%. At the same time, the gap in living standards with Western neighbors has further widened.

3. As the result of the dramatic political changes in Eastern Europe over the past year, the prospects for reforms may, however, have changed considerably. Free elections are to be held in late March 1990, and an entirely new government may be in place soon thereafter. Similar changes in other Comecon member countries may lead to a rapid movement from central planning toward "social" market economies similar to those in Western Europe. External constraints, such as the continued existence of rigid Comecon trade arrangements, may thus disappear far more rapidly than had been thought possible even six months ago.

Recent Economic Developments

4. Some progress has been made since 1987 in implementing reforms designed to move Hungary, albeit very gradually, toward competitive markets, increased entrepreneurship and improved resource allocation. A more neutral and efficient tax system has been introduced, initial steps to transform the financial system have been taken, and the wage system was liberalized to enable enterprises to determine individual

wages freely, while keeping some indirect control over the increase in the total wage bill. Legislation was enacted to transform state enterprises to convert into joint stock corporations in which individuals can hold shares, and the legal ceiling on private sector employment has been raised from 30 to 500. Recent economic performance has been mixed. Convertible currency exports have increased satisfactorily, but the current account deficit has increased due to tourist spending and unrecorded capital transfers. At the same time, the current account surplus with the non-convertible area has increased and has been an important factor in excessive domestic demand pressures, with inflation increasing to 18% in 1989. The forint has been devalued in December to partially compensate for the loss in external competitiveness.

The Government's New Economic Reform Program

5. The proposed Structural Adjustment Loan would be in support of the government's recent program to broaden and accelerate the transition towards a more flexible and efficient market economy. The program builds on the reform measures introduced over the past three years and covers further reforms of enterprise ownership, management and control; liberalization and development of the financial system; further liberalization of foreign trade; deregulation of domestic markets and prevention of unfair trading practices; and reforms in social policy, including gradual reductions of consumer subsidies. These structural reforms are to be accompanied by adoption of a satisfactory macro-economic framework to be supported and monitored through a separate IMF program.

The Committee May Wish to Discuss the Following:

6. Macro-Economic Policies

- The authorities have repeatedly been unable to adhere to their macro-economic targets. What is different this time?

- Does the Region believe that the underlying exchange rate policy (approximate maintenance of the real effective exchange rate) is sufficient in view of the proposed program of further import liberalization?

- Would it be safer to adopt more flexible, market-clearing exchange rate system, particularly in view of the intended sharp reduction of the current account deficit?

7. Privatization and Enterprise Reform

- What is the likely effect of the intended mandatory incorporation of all state enterprises and cooperatives? Does this resolve the fundamental problems of state enterprises in Hungary?

- What is the rationale for retaining limits on private sector employment?

8. Foreign Trade

- Why are tariffs reduced ahead of the removal of quantitative import restrictions? Why are targets for liberalization of quantitative trade restrictions so cautious (70% by 1992)?

- What are the Regions views about the scope and timing of Comecon trade reforms? Are the proposed interim measures sufficient to avert recent problems of trade diversion and excessive domestic credit expansion?

9. Fiscal Issues

- Why is it not possible to agree now on a quantitative target for reductions in budgetary subsidies by the time of the second tranche release?

10. Financial Discipline and Enterprise Restructuring

- Would it not be desirable to have more specific conditionality with respect to the liquidation of large loss-making state enterprises as part of the second tranche review?

11. Timing

- Given the political uncertainties in Hungary, would it not be desirable to wait until after the upcoming elections to agree on an adjustment and reform program with the new government?

Bank Exposure and Burden Sharing

12. Given Hungary's excessive level of external debt, additional net disbursements by the Bank will lead to an increasing share of the Bank in total debt, while other private and official creditors are likely to reduce their net exposure. Can this be justified?

cc: Messrs./Mmes Qureshi, Shihata, Wood, Rajagopalan/Fischer, Kashiwaya, Jaycox, Karaosmanoglu, Wapenhans, Husain, Vergin, Lari, Goldberg, Lee, Shakow, Holsen, Bock, Rao, Picciotto, Burmester/Thahane, Nouvel, Okonjo-Iweala, Pant

For Information Only

cc: Messrs./Mmes Thalwitz, Parmar, Pfeffermann, Linn, Kavalsky, Haug, Liebenthal, Kilby, Robless/Lawrence, El Maaroufi, Khanna

GPohl:sb

February 2, 1990

THE WORLD BANK

Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee to consider PAPUA NEW GUINEA: SAL (Initiating Memorandum held on February 2, 1990 in Room A-1243

A. Present

Committee	Others
Messrs. W.A. Wapenhans (Chairman)	Messrs. A. Bhattacharya (AS5CO)
K. Kashiwaya (CFSVP)	F. Chaudhri (EAS)
H. Scott (LEGVP)	P. Crevier (SECGE)
R. Cheetham (AS5FR)	Ms. M. de Nevers (FRSCR)
H. Fleisig (LAC)	V. Dubey (EAS)
F. Kilby (FRSCR)	Ms. K. Nordlander (LEGAS)
P. Meo (IECIT)	C. Obidegwu (SPRPA)
S. O'Brien (AFRCE)	A. Singh (ASIVP)
	K. Siraj (COD)
	J. Strongman (AFTIE)
	I. Zincir (AS5DR)

B. Issues

Economic Advisory Staff had prepared an agenda for the meeting focussing on three major issues: the relative balance between macroeconomic stabilization and adjustment, the Government's ability to implement the program, and the tranching and conditionality of the loan.

C. Discussion

The Region began the discussion by providing an update on developments in PNG. The situation in Bougainville had deteriorated and it was extremely unlikely that the mine would reopen next year. Events at Bougainville have also led to an outflow of workers from cocoa plantations. This would add to the effects of the mine closure since Bougainville accounts for about 30% of cocoa production in PNG. The Region was concerned about the deflationary impact of these events. The

Base Case in the CSP, therefore, was more like the optimistic case. However, the program in the SAL had been designed on the likelihood that the mine would not reopen in January, 1991. With other mines coming on stream, the situation was manageable.

In response to a question on the respective roles of the Bank, IMF and ADB, the Region responded that ADB and the Bank had been discussing structural reforms for some time. The Bougainville crisis has enhanced the urgency of these reforms. An ADB agricultural program loan for $80 million was approved in November, and around the same time the Government approached the IMF and World Bank for support for the stabilization and adjustment program. The Government has requested the IMF for both a Compensatory Financing facility loan and a standby loan for a total of $90 million. The Bank and Fund propose to have parallel missions and joint meetings. The proposed Bank SAL would be for $50 million, in two tranches, leaving a gap of about $35 million in this calendar year, to be covered by Australia and other donors.

A member asked about the implications of the worsening in the Bougainville situation for the country's creditworthiness. The Region noted that the country was rich in mineral and natural resources and there were a number of mineral developments underway that would by 1993 more than offset the shortfall in the earnings from Bougainville. The Region had been following these investments closely and they remain on track. The Government was also responding promptly to the current shortfall. The Region's assessment, therefore, was that PNG's creditworthiness would remain sound in the medium- and longer-term. The Government was also willing and able to tackle the basic issues.

In this regard, another member observed that the market reaction to the closing of the mine was very bad and asked about the prospects for PNG to access private markets to meet its investment requirements including in the mineral sector. The Region responded that mining sector investments were already being financed entirely by private capital, but in the medium-term there would appear to be good possibilities to use private capital for project finance. In that regard, the expanded cofinancing facility may be an important tool although in the immediate term recourse to private finance would have to be limited. The Region said that at the moment the country had difficulty in accessing the market but the situation would not last indefinitely.

The Chairman and several members asked about the balance between stabilization and adjustment and the extent to which the Government had focussed on the key structural issues. The Region responded that a sound macroeconomic framework was an essential prerequisite for adjustment, and there was agreement between the IMF and the Bank on the key parameters. In the case of PNG, the main structural issues were the lack of competitiveness because of wage and exchange rate policies and the weak investment effort because of absorptive capacity constraints. The Bank has been discussing these issues with the Government for the past two years with, for instance, two absorptive capacity missions recently visiting the country. The Bank has undertaken considerable work to identify a much needed, well-focussed investment program and major bottlenecks. The present situation has provided an opportune occasion to address these structural problems.

One member noted that the IM appeared to give emphasis to stabilization measures. Recognizing that the IM had been prepared quickly in response to the urgent request of the Government, he suggested that more attention be focussed on structural reforms particularly in view of the parallel IMF standby operation. He asked if, given the introductory remarks of the Region, the IMF could consider an EFF rather than one-year standby. Another member observed that what was needed was to establish institutions which would ensure that key policies such as attractive exchange rates and complementary wage policies remain on track.

The Chairman asked the Region to respond to questions on implementation capacity, particularly on structural reforms. The Region noted that the agenda on structural reforms had intentionally been kept limited to take into account constraints on implementation capacity. On the public investment program, the Government has made considerable progress in developing a well-articulated and focussed program, and on this basis, there was now a good understanding of investment and expenditure priorities. Similarly, the Government has formulated an administrative reform program, that would provide the basis for organizational and procedural reforms. Finally, wage and exchange rate policy remained a difficult area, but the Government had given a clear indication of its commitment by announcing the recent devaluation.

In response to a question from the Chairman on the implications of labor absorption because of the mine closure, the Region noted that a separate mission would be mounted to identify an accelerated program of projects to offset some of the employment and income effects of the mine closure. One aspect that would be looked at is how to employ and utilize the skills of the 2,000 workers who would be released from the mine and would be receiving roughly K20 million in compensation payments.

Finally, the Chairman observed that the program was heavily tilted towards stabilization and asked whether wage rate and other targets were consistent with Fund views and whether the Bank would proceed without an IMF standby. The Region responded that the macroeconomic targets were consistent with Fund staff views and that the Bank had made clear to the Government that it would proceed only with a seal of good approval from the IMF. The Chairman concluded that it would be important to have an IMF standby operation in place, and asked that the Region consult again with the Committee if the standby did not materialize.

The Region was authorized to appraise the SAL, taking into consideration the key concerns and observations noted above.

February 6, 1990

ABhattacharya/FChaudhri:gs

200730009 1.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: January 29, 1990

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXTENSION: 78051

SUBJECT: PAPUA NEW GUINEA: Structural Adjustment Loan
Initiating Memorandum - Agenda

The Region has distributed the Initiating Memorandum (IM) on a $50 million SAL to Papua New Guinea on Friday, January 26, 1990. The Operations Committee will meet on Friday, February 2, 1990 at 4.00 p.m. in Room E-1243 to consider the IM.

(a) Background

The closure of the Bougainville copper and gold mine in May 1989 has presented the Government of Papua New Guinea with a substantial challenge to stabilize the economy and to undertake structural reforms to develop the non-mining sector. The loss of export earnings from the closure of the mine would cause Papua New Guinea a loss of some 38% of export earnings and 17% of government revenues for a year. There is considerable uncertainty whether the mine would reopen as planned in 1991. Meanwhile the prices of the country's non-mineral exports have fallen. These recent events underscore the need and the occasion to diversify the country's export earnings and to realize the potential of the non-mining sector. The structural reforms proposed in the IM are in accord with the Country Strategy paper now under completion by the Region.

The country has reacted promptly to this large supply shock by adopting strong contractionary policies, with a devaluation of the kina and is planning to take further measures to reduce and redirect expenditures. It seeks the Bank's support to undertake a structural adjustment program.

The proposed program articulated in the IM will comprise 3 elements, namely, macro-financial framework for stabilization; improvement in public resource management and incentive reforms to promote the non-mining sectors. The macro financial aspects of the SAL will be closely coordinated with the Fund which will be discussing a compensatory financing facility and a possible stand-by arrangement with the government of Papua New Guinea at the same time the proposed SAL is being discussed with the Government.

(b) Issues

Macroeconomic Stabilization and Adjustment

- The Region may be asked to define the division of labor between the Bank and the Fund given that the major short-

term issue is to stabilize the economy in response to the loss of export earnings and government revenues.

- Given that the program contains many monetary targets in relation to domestic credit, interest rates and external borrowing, the Region may be asked to define possible ways to stabilize the economy in the event a stand-by program is not reached or is delayed beyond the timing anticipated for the SAL.

Implementation Capacity

- The Region may be asked to discuss the feasibility of the Government undertaking a wide ranging program of structural reform that extends beyond the fiscal reforms to sector specific reforms in agriculture, rural credit, and the social sectors.

- The Region could be asked to evaluate the likelihood of success of the planned reforms given the past difficulties in coordinating central and provincial government policy actions, land acquisitions and difficulties in raising additional revenues.

- Will there be sufficient political commitment to sustain implementation given that there will be strong resistance to the wage and civil service reform?

Conditionality and Tranching

- The Region might explain the importance of the Government reaching agreement with the public sector trade unions to limit nominal wages since without it the required relative price adjustment might not take place necessitating a strong contraction with implications for reduced growth and higher unemployment.

- The Region might explain as to why the second tranche is to be released within six months of effectiveness of the loan while the structural reforms will extend well beyond this period.

Operations Committee

Messrs. M.A. Qureshi, S. Husain, E. Jaycox, A. Karaosmanoglu, W. Wapenhans
V. Rajagopalan/S. Fischer, I. Shihata, K. Kashiwaya, D.J. Wood
H. Vergin

cc: Messrs. D. Lee, A. Shakow, J. Holsen, D.C. Rao, D. Bock,
S. Burmester/T. Thahane, D. Goldberg, Ms. Okonjo-Iweala
S. Rajapatirana, W. Thalwitz, J. Parmar, J. Linn, B. Kavalsky,
G. Pfeffermann, R. Liebenthal, F. Kilby, C.L. Robless,
Ms. M. Haug, A. Khana, F. Aguirre-Sacasa, K. Challa,
R. Cheetham, A. Bhattacharya

SRajapatirana:gs

WORLD BANK OTS SYSTEM
SENIOR VICE PRES. OPERATIONS

CORRESPONDENCE DATE : 90/01/26 DUE DATE : 00/00/00
LOG NUMBER : 900129009 FROM : KARAOSMANOGLU
SUBJECT : PAPUA NEW GUINEA - SAL IM

OFFICE ASSIGNED TO FOR ACTION : Mr. Dubey (E-3-069)

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 ______

COMMENTS :PRIROITY #1

January 12, 1990

THE WORLD BANK

Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee to consider MEXICO: Road Transport and Telecommunications Sector Adjustment Loan held on Friday, January 12, 1990 at 11.30 a.m. in Room E-1243

A. Present

Committee		Others
Messrs. M.A. Qureshi (Chairman)	Messrs.	E. Grilli (EAS)
S. Husain (LACVP)		R. Halperin (LA2IE)
A. Karaosmanoglu (ASIVP)		A. Heron (CODOP)
K. Kashiwaya (CFSVP)		T. Hutcheson (SPRPA)
H. Scott (LEGVP)		R. Laslett (FRSCR)
F. Colaco (PRSVP)		K. Mettala (LEGLA)
H. Messenger (AFRVP)	Ms.	N. Okonjo-Iweala (OPNSV)
C. Michalopoulos (EMNVP)		S. Rajapatirana (EAS)
D.C. Rao (FRS)		R. Steckhan (LA2DR)
		S. van Wijnbergen (LA2CO)
		B. Wellenius (ASTIF)
		S. Vital (IDB)
		A. Paz Estenssoro (IDB)

The Operations Committee met to discuss the Initiating Memorandum (IM) on the proposed Road Transport and Telecommunications Sector Adjustment loan to Mexico. The discussion broadly followed an agenda prepared jointly by the Economic Advisory Staff and the Country Operations Department.

The Chairman invited the Region to introduce the IM. The Regional staff indicated that the proposed loan supports the continuing process of adjustment in Mexico. The loan would help to alleviate a structural constraint to growth and was closely linked to the adjustments in the other sectors. Meanwhile the macroeconomic program in Mexico has been on track providing a favorable environment for the loan.

Taking up the first item on the agenda, the Chairman asked why an adjustment instead of an investment loan was proposed to assist road transport and telecommunication sectors. The Committee member from the Region explained that an adjustment loan was needed as support for the other major reforms undertaken by Mexico in the trade, financial sectors and in the public sector in order to increase the domestic mobility of goods and factors. The adjustment policy measures supported by the loan were an essential corollary to the liberalization of external trade with implications for the balance of payments. In addition, investment loans to support the overall transport sector in ports and railways were under implementation.

The Chairman then raised the issue of the amount of the loan, as to why a $400 million loan was necessary. The Committee member from the Region indicated that this amount was broadly in line with the overall macroeconomic situation and was consistent with the Bank's assistance strategy to help Mexico reduce its external debt and to provide new money.

A Committee member noted that the cumulative amount of finance provided for Mexico was rather large and wondered whether these loans were leading to adequate reforms. In reply the Regional staff referred to the substantial reform program undertaken by Mexico, extending to trade, finance, public sector reforms, privatization, agriculture and steel. The same Committee member also asked whether the Region could quantify the relationship between reforms and its effects on growth. The regional staff indicated that the savings in costs arising out of the reforms taken as indicative of the direct pay-off to reforms, were substantial but that more indirect growth effects of deregulation could not be easily quantified at this stage in Mexico. Other countries, however, provided evidence of significant effects on growth.

A Committee member inquired whether privatization of Telmex could be accomplished by the release of the second tranche. The Regional staff explained that privatization in this instance involved increasing the private ownership of the share of equity from 49% to 51%. The stock of Telmex was already traded in the New York Stock Exchange and the Government was fully committed to privatization as demonstrated by the recent privatization of two Mexican Airlines.

A Committee member raised the issue whether some of the conditions to be met for the road transportation component were already included in earlier loans. The Regional staff explained that while the the Ministry of Communications and Transport had a mixed record in implementing an earlier investment loan, it was now committed to undertake reforms given that their own budget had been cut and they needed outside support for their program. Also, earlier conditionality on the transport sector included in the industrial sector loan was for a study which is under preparation.

A Committee member raised the issue of the level of the telecommunications tariffs compared to international standards and whether the rigidity of the labor market in Mexico was an important macroeconomic adjustment issue. The Regional staff explained that the tariff structure was distorted. While the domestic telephone tariffs and rentals, for example, were low, the tariffs on international calls were very high. Hence the need to restructure telephone tariffs which was an important condition of the loan. With respect to labor market rigidity, while this has been a problem in the past, the recently negotiated contract with the union has given management more flexibility to re-deploy and retrench staff.

A Committee member raised the issue of the institutional commitment to sustain reform and the incentives provided for the purpose. The Regional staff stated that the role of the Ministry of Communications and Transport was crucial for the success of the reforms. Accordingly, Bank strategy has emphasized reform of the Ministry, differentiating between its regulatory and operating functions. The institutional reforms emphasized the need to separate these functions recognizing that the Ministry had statutory responsibility to operate in the sectors for example in the area of satellite communications. The Chairman pointed out the importance of the institutional reforms given that many multilaterals were interested in the telecommunications sector in developing countries and a strong and competent regulatory body was needed to license equipment and to grant franchises for an array of services. The Regional staff indicated that the Mexican authorities were reviewing the existing regulations. The boundaries between competition with the private sector and regulatory functions of the Ministry would be carefully drawn in reforming the institutions.

A Committee member remarked that in the telecommunications sector component of the loan there were three elements to be considered, namely divestiture, a competition policy statement and the ability to develop a regulatory framework. He asked whether the Government was up to the task. The Regional staff recognized the difficulties inherent in the wide ranging reforms proposed and indicated that reforms were to be a continuing process. They would follow progress at each step. Developing a regulatory framework was an important step in the process. Many of the regulatory policies need to be clarified first and the Ministry has to be strengthened to carry out its new mandate. The Region will work with the Government to appoint competent consultants to identify the needed institutional reforms, including a manpower development program. Another Committee member indicated that the conditions itemized in the policy matrix need to be carefully related to the discussion in the text.

A Committee member asked whether a 2% change in the ownership of Telmex meant a major change in the way the company operated and whether privatization in this context would be credible. The Regional staff indicated that this change in ownership would lead to the management of the enterprise by the private sector. This would send an important signal that the Government was seriously committed to fundamental change in the sector as well as in other sectors. A Committee member remarked that since telecommunications were one of the most promising sectors to be privatized, with the capital market progressing at the present rate, there should not be any problem in implementing a larger privatization.

The Chairman raised the issue whether the policy changes included in the loan go beyond the period of disbursement of the loan. The Regional staff indicated that the majority of the policy conditions would have to be met before Board presentation. A Committee member asked whether there was to be a negative list for procurement under the loan. The Regional staff indicated that they had already requested the Government to look into the import needs of the two sectors, account for the imports that could be financed by export credit agencies and then develop a positive list for imports. A negative list would only be proposed if the data were to show that the positive list would not allow quick disbursement of the loan proceeds. A Committee member referred to the prospects for cofinancing with Japan and asked whether a specific agency was in mind such as the OECF or the Export Import Bank of Japan. As far as he was aware, there were no clear prospects for cofinancing this loan with these agencies at this stage. At the close of the discussion, the Region noted that the Technical Assistance component of the project could be recast as a stand-alone project.

In endorsing the overall design of the loan, the Chairman suggested that the project document should indicate clearly the relationship of the loan to the ongoing reforms and make the case as to why it is an integral part of the overall reform program and as an essential corollary to the external liberalization. The document should also give a full account of the medium term macroeconomic developments and place the loan in the context of these developments given that it is an adjustment loan. As far as possible the Region should attempt to develop a positive list for procurement under the loan.

January 19, 1990
SRajapatirana/EGrilli:gs

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: January 9, 1989

TO: Operations Committee

EG

FROM: Enzo Grilli, Acting Director, EAS

EXTENSION: 78061

SUBJECT: MEXICO: Initiating Memorandum (IM) on Road Transport and Telecommunications Sector Adjustment Loan

Macro Policy
in text
too many conditions

The Operations Committee will meet on Friday, January 12, 1990 at 11.30 a.m. in Room E-1243 to discuss the Initiating Memorandum on a proposed Road Transport and Telecommunications Sector Adjustment Loan to Mexico.

Introduction

The proposed loan of $400 million to the road transport and telecommunications sectors supports adjustments which are required to develop a suitable framework for private sector led growth through changes in the policy environments and investments in these sectors. A part of the loan amount, $100 million is earmarked as a "set aside" for debt reduction. The Inter American Development Bank (IDB) is expected to provide $200 million as co-financing. The IDB's processing is expected to parallel the Bank loan and would propose equal conditionality. The main elements of the road transport component deal with trucking deregulation and would monitor the implementation of already announced measures while promoting additional measures to open entry into the sub-sector. These measures are aimed at rationalizing pricing, taxation and cost recovery, promoting highway safety, increasing highway maintenance and assisting the reorganization of the road transport regulatory staff of the Ministry of Communications and Transport. In respect of the telecommunication sector, the principal components of the project are the privatization of Telmex (the national telephone monopoly), policy reforms to promote competition, rationalize tariffs and taxes and the regulatory environment so as to encourage the adoption of new technologies.

The policy reforms in the road transport and telecommunication sectors are seen as essential to the emerging phase in Mexico's recent development. As Mexico Stabilization program progressively consolidates, the present loan supports both additional financial resources to alleviate directly the debt overhang, and to restore much needed growth in the economy. The proposed loan follows significant policy loans that have liberalized the trade regime and financial sector reforms that have restored the allocative role for interest rates. The debt overhang issue is being addressed through an interest reduction loan based on an agreement with the commercial banks supported by the Bank and the IMF.

Issues

The Nature of the Loan

- The Region might wish to comment on the rationale for an adjustment loan to support the policy changes and investments in the road transport and telecommunication sectors when the policy changes could go beyond the disbursement period of the loan.

- The Region may also wish to comment on the macroeconomic conditionality that is implied in the loan, in particular the satisfactory assessment of the medium term macroeconomic framework identified as a condition for Board presentation (paragraph 87(1)

The Sector Focus

- The Region may wish to comment on the choice of the loan to support the road transport and telecommunication sub-sectors, given that many of the issues relating to resource allocation in the overall transport sector would concern other modes including railways, urban transport, passenger vehicles and may have implications for traffic growth, road safety and fuel use in other modes.

Pricing and Cost Recovery

- The Region may wish to clarify the basis for the recommendation of increasing the domestic price of diesel by 8% in real terms over the December 1989 level when the domestic diesel price already exceeds the border price and other users of the fuel would be penalized (paragraph 39).

- The Region may also wish to comment on the constraints placed on price adjustments in the railway sector due to the ongoing stabilization program. Would this lead to cross subsidies between rail and road transport?

Privatization of the Telecommunication sector

- What does the Region perceive as a viable method for privatizing Telemax. Is the domestic capital market broad enough to ensure proper valuation of the assets of Telemax and to ensure wide ownership of the shares?

Any Issues? bilateral relations

Macro Economic Policy

Operations Committee

Messrs: Qureshi, Husain, Jaycox, Karaosmanoglu, Wapenhans
Rajagopalan/Fischer, Shihata, Kashiwaya, Wood, Vergin

cc: Messrs. Lee, Shakow, Holsen, Rao, Bock, Burmester/Thahane,
Goldberg, Ms. Okonjo-Iweala, Ray (o/r), Thalwitz,
Parmar, Linn, Kavalsky, Pfeffermann, Liebenthal, Kilby,
Robless, Ms. Haug, Khanna, Steckhan, Martinez, Halperin

Rashid/Rajapatirana:gs

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Lending Allocations 37 — 22 Request Proposed

DATE: January 2, 1990

TO: Operations Committee

FROM: Enzo Grilli, Acting Director, EAS

EXTENSION: 78061

SUBJECT: MAURITANIA - Public Enterprise Sector Adjustment Program and Technical Assistance Project; Initiating Memorandum; Operations Committee Meeting; Agenda

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1. The Operations Committee will meet on **Friday, January 12, 1990, at 10:30 a. m. in Room E1243** to consider the Initiating Memorandum for the Mauritania Public Enterprise Sector Adjustment Program and a corresponding Technical Assistance Project. The following represents a proposed agenda.

Background and Macroeconomic Overview

2. Since 1985, the Government has undertaken measures to redress the serious macroeconomic disequilibrium and economic restructuring. This has been supported by the IDA with a SAL in June 1987. The second tranche of this SAL was released in November 1988. Performance under the SAL has been judged by the Region as satisfactory, although relatively slow. A major cause of the economic difficulties of Mauritania stems from a large public sector deficit, caused in part by a large public enterprise sector.

3. A PFP for 1989-91 currently supports the macroeconomic and policy framework. The annual growth target is 3.5% for real GDP. This is supported, among others, by market-based policies, fiscal austerity, and public sector restructuring. The ethnic disturbances in the spring of 1989 has led to the influx of refugees from Senegal, thus further straining government resources and complicating the adjustment problems.

4. CSP Status. On July 14, 1989, the Committee met to consider the CSP for Mauritania. The Committee at that time did not make a final decision on the lending program until after a report had been made on the donor's meeting that took place soon after. That report had not, as of this time, been made by the Region to the Committee.

5. The Committee may want the Region to apprise it of the results of the donor's meeting, the recent developments in Mauritania, and the implications of these on the lending strategy, as required by the Committee in its discussion on the CSP. As a background, the CSP

proposed a lending program under an adjustment scenario composed of a PESAP and an Agricultural SECAL requiring US$45 million from the IDA for 1990. In accordance with this plan, the PESAP credit allocation from IDA was US $20 million. The present PESAP IM proposes an IDA credit of US $45 million, including the TA project component, which therefore uses up the plan for 1990. In answering this issue, the Region may want to address the following:

- Is the Region pursuing a high adjustment scenario, considering that the proposed credit under the present IM is higher than under the CSP? (Note: Recall that the CSP considered in July called only for two scenarios: a slow or no adjustment scenario and a moderate adjustment scenario, the latter being the basis of all the current PFP and base case projections.) If so, what specific adjustments are being undertaken, especially at the macroeconomic level, considering that the Region had judged the recently completed SAL as producing relatively slow reforms (para. 2, above)? For instance, are the PFP targets for 1989 fulfilled?

- Has there been a shift in priorities for the sectors in Mauritania's economy in view of the proposed level of lending allocation?

The Public Enterprise Sector

6. The Committee may want to ask the Region to provide more information on Bank interventions in the public enterprise sector in Mauritania and to what extent these operations have succeeded. In particular, paras. 13 and 14 of the IM give a capsule of the problems and Bank experience, and suggest that these reforms have either failed or have not been undertaken adequately.

7. In particular, the Committee may want the Region to:

- to elaborate on the depth of public enterprise reforms, considering that a number of major enterprises considered "strategic" by the Government would continue to be in public ownership;

- to discuss the feasibility of privatizing the major companies, especially SNIM, or, at the very least, removing government backing or guarantee for their financial operations; and

- to discuss the feasibility of achieving divestiture targets for nonstrategic industries (second and third tranches) within the time constraints, considering the known difficulty of this process; who are the buyers of these companies?

8. SNIM Debt Relief Issue. The bulk of the proposed operation is designed to provide debt relief to the SNIM. The Region argues that this is crucial to the SNIM's survival, and that some donors have already provided debt relief. The proposed PESAP is substantially financed by IDA with other cofinanciers and would provide SNIM with US $75 million in equity and soft loans to refinance the debt, or allow SNIM to prepay its debt. SNIM's total long-term debt of US $235 million includes still an outstanding debt of US $43 million to the World Bank, out of the original loan of US $60 million in 1979.

9. The Region is asking the Committee for guidance on the issue of utilizing the credit proceeds for the restructuring of SNIM's debt, through a loan of the Government to the enterprise utilizing the proceeds of the PESAP Credit. The Committee may want to deliberate on the issue of whether the overwhelming need for debt relief for Mauritania would justify an IDA credit refinancing, in effect, a Bank loan.

10. Project Risk. The debt relief for SNIM depends critically on the project assumptions about iron ore prices, exchange rates and the achievement of targetted capacity increase to 10 million tons production (which depends on the Guelbs expansion phase, still to be achieved). Furthermore, the overall PESAP would be constrained by the capacity of the authorities to carry out the proposed reforms, which are not simple in nature. The Committee may want to ask the Region for further discussion of the project risks, given the Government's past performance in other Bank/ IDA operations.

The Proposed Credit

11. The total adjustment program involves a financing of US $150 million, with an IDA financing of US $45 million, including a US $5 million TA project. The Credit is proposed to be disbursed in three equal tranches over a 24 months period after effectiveness against a positive list of imports of strategic commodities, following the SAL.

12. The Committee may want to ask the Region whether the level of financing does not justify a higher level of front-loading of Government actions upon effectiveness.

13. Donor Coordination. A high degree of donor coordination is required because of the high external debt level of Mauritania and the overall economic and social implications of the refugee problems with Senegal. The Committee may want the Region to elaborate on the extent of donor coordination and to detail the expectations of other donors of the role that the Bank may play.

Implications of Refugee problems; Technical Assistance Project

14. The Region suggests the possibility that the Government would not be able to carry out the reforms considering their high short run costs, especially in unemployment, in view of the demands of the

refugee issue. The Committee is being asked by the Region if it could proceed to send an appraisal mission, even while awaiting the results of a donor's meeting to be held in January on how the government plans to proceed with the reforms, and secondly to send a joint mission for the appraisal of the PESAP and the Technical Assistance Project although these are conceived as separate operations.

cc: Messrs./Mmes Qureshi, Shihata, Wood, Rajagopalan/Fischer, Kashiwaya, Jaycox, Karaosmanoglu, Wapenhans, Husain, Vergin, Gillette, Goldberg, Lee, Shakow, Holsen, Bock, Rao, Burmester/Thahane, Bauer, Okonjo-Iweala, Menezes

For Information Only

cc: Messrs./Mmes Thalwitz, Parmar, Pfeffermann, Linn, Kavalsky, Haug, Liebenthal, Kilby, Challa, Robless/Lawrence, Khanna, Agarwala

GRS
GSicat:sb

Sector Conditionality — Divestiture —

Macro Conditionality

Qureshi
E 1241

January 10, 1990

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THE WORLD BANK
OPERATIONS COMMITTEE

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Minutes of the Operations Committee to Consider
SRI LANKA--Economic Restructuring Credit, Initiating Memorandum

Held on Wednesday, January 10, 1990 in Room E 1243.

A. Present

Committee	Others
Messrs. M. A. Qureshi (Chairman)	Messrs/Mss. E. Grilli (EAS)
S. Fischer (DECVP)	P. Ljung (EAS)
A. Karaosmanoglu (ASIVP)	S. Asanuma (AS1DR)
K. Kashiwaya (CFSVP)	A. Clift (AS1CO)
W. Wapenhans (EMNVP)	Y. Huang (AS1CO)
H. Scott (LEGVP)	N. Zagha (AS1CO)
D. C. Rao (FPRVP)	F. Johansen (ASIVP)
M. Selowsky (LACVP)	A. Harth (CODOP)
H. W. Messenger (AFRVP)	T. Hutcheson (SPRPA)
	J. Katz (FRM)
	H. Darmawi (LEGAS)
	N. Okonjo-Iweala (OPNSV)
	K. Saito (IMF)

B. Issues

1. In August last year, the Government of Sri Lanka embarked on a Fund supported stabilization program to halt the accelerating deterioration of the country's economy. The Government also requested IDA support for an ambitious structural adjustment program aimed at improving the efficiency of public administration, expanding the role of the private sector and enhancing the welfare of the poor. As presently envisaged, IDA would support this program through the proposed Economic Restructuring Credit and through a Public Enterprise Restructuring Project (FY91) and a Poverty Alleviation Project (FY91S). The discussion of the Initiating Memorandum for the Economic Restructuring Credit (ERC) broadly followed the agenda prepared by EAS.

2. In opening the discussion, the Chairman noted that the Government's economic program--as presented in the IM--focused heavily on stabilization measures; in the budget area, this involved primarily cutting down poorly targeted and costly transfer programs. What was IDA's role in this context? Although the economic projections showed an acceleration of growth, the Chairman asked wether the ERC contained enough structural reforms to elicit a sufficient supply response to get the economy back on a rapid and sustainable growth path. He also noted that the stabilization measures would be hard on the poor. Would it not be possible to add a specific component under the ERC which would be aimed at protecting them?

3. In responding to the Chairman's questions, the Region described the structural weaknesses of Sri Lanka's economy, the Government's reform agenda and the Bank's role in supporting these reforms. Traditionally, the Government had played a major role in the economy. Social sector spending had long been large for a country at Sri Lanka's income level, but the results--in terms literacy, health and poverty alleviation--were impressive. Over the years the government had increasingly become involved in plantation agriculture, manufacturing and marketing activities. The small private sector had been overly protected and heavily regulated. The economic reforms initiated in 1977 had dealt primarily with the incentive and regulatory frameworks for private enterprises in selected manufacturing and marketing activities. The increase in efficiency and the supply response to these reforms had been impressive. However, little had been done to change the fundamental role of the government and the large size and inefficiency of the public sector had gradually become the main obstacles to accelerated growth. In addition, election politics a year ago had led to a new and non-sustainable expansion of subsidies and welfare spending. Since the scope for enhancing government revenues was limited, the key measures had to be taken on the expenditure side (in combination with tighter monetary policy and exchange rate adjustments).

4. Consequently, the main role of IDA in this phase of the stabilization process was to help guide--and finance--the public sector retrenchment, to ensure its smooth implementation and to enhance the efficiency of public investments and recurrent expenditures to create the conditions needed for economic growth. IDA would also help improve the cost-effectiveness and targeting of transfer and social welfare programs in order to protect the living standards of the poor. At the same time, IDA was supporting restructuring and privatization of public manufacturing, trade and transport enterprises and tea estates. Over time, these reforms would enhance efficiency and get the economy on to a higher growth path. As explained in the IM, this program was largely based on the work of the Presidential Tariff, Administrative Reform and Industrial Tariff Committees and studies carried out under a PPF approved in 1988. The present administration was firmly committed to the program. Unfortunately, more preparatory work was needed before a revised poverty alleviation program can be put in place. Similarly, more thought had to go into the process of enterprise and estate restructuring and privatization.

5. The Chairman and several other speakers noted that IDA was indeed supporting structural measures that were essential to meet both poverty alleviation and growth objectives. However, the presentation in the IM put too much emphasis on the stabilization part of the program, i.e. the reduction of expenditures, rather than on the retargeting and enhanced efficiency of public expenditures. The President's Report (PR) needed to give a more complete view of the Bank's interventions. Similarly, the PR should be more explicit on the linkages between the action in the policy matrix and the macro-economic outcome, especially in terms of their budgetary impact.

6. In response to a question, the Fund representative provided a brief overview of the SAF arrangement and described the response to the measures taken so far. The results were quite encouraging. Monetary targets had been observed. Foreign exchange reserves had increased by US$165 million since August. Although no firm data on output growth are available, the general

impression was that the private sector has responded favorably. The only worrying sign was that a December through December inflation rate of 15 percent. However, this was probably due mostly to the Government's decision to raise wheat, rice and petroleum prices and to devalue the rupee. The next Fund mission was scheduled for April when the present program will be reviewed and a third year SAF (or an ESAF) arrangement will be discussed.

7. Several speakers noted that there appeared to be some gap between the time when the present welfare programs were curtailed or terminated and the food stamp program retargeted (and possibly enhanced for the lowest income groups) and the time at which the new poverty alleviation program would become effective. The Region responded that the appraisal mission would give special consideration to the appropriate transitional arrangements. The Chairman noted that this intention to protect the poor should be clearly reflected in the policy matrix and the credit conditions.

8. Several speakers had questions about the nature and sequencing of the structural reforms that were needed to get a significant supply response from the private sector. Although the measures in the policy matrix seemed rather weak and possibly slow to take effect, exports were expected to expand rapidly and overall growth was assumed to reach 4 percent as early as 1992. In its response, the Region noted that volatile commodity prices had tended to obscure the basic trend in real exports. Future export growth was expected to come primarily from continued expansion of non-traditional exports--but at a lower rate than what had been experienced in recent years. Given the anticipated depreciation of the rupee and a further reduction in the effective rate of protection, this export performance was not unrealistic. Much had already been done to improve the trade regime. Essentially all quantitative restrictions had been removed (except those aimed at protecting certain public enterprises). The maximum tariff had been reduced to 60 percent. A further streamlining of the tariff structure and a reduction of the top rate to 50 percent was part of the ERC. Domestic restrictions on "entry" were similarly aimed at protecting public monopolies. Thus, future structural reforms should focus on the restructuring and privatization of public enterprises and on the regulatory reforms needed to create a competitive environment in these protected enclaves. A number of measures were already included in the ERC and others would follow under the Public Enterprise Restructuring Project. In response to a question, the Region also explained that the modalities for enterprise reform would vary (as they had in the past) depending on the nature of the enterprise and the sector. In some cases, equity would be sold; in others, assets. The buyers could be either Sri Lankan enterprises or individuals or foreign firms. Management contracts with private firms was a likely option in the tree crop sector. Although there were some dangers in trying to rush these reforms, several members noted that it would be desirable to accelerate the public enterprise reforms and to tighten the conditionality.

C. Decision

9. In concluding the meeting, the Chairman noted that the ERC would support important structural reforms aimed at enhancing the efficiency of public investments and recurrent expenditures, protecting the poor and expanding the role of a competitive private sector. It was essential that the President's Report clearly reflected that the Government's economic program went far beyond the Fund sponsored stabilization measures, and that IDA's support, through the ERC, focused on these broader adjustment measures. This

was not only a matter of presentation, but also of the substance of the conditionality. Special emphasis should be given to the social aspects of the program. The report should clearly explain the waste and lack of direction in the existing subsidy and welfare programs and demonstrate how the reforms will actually improve the welfare of the poor.

D. Follow-up Meeting

10. The Region met separately with Mr. Fisher to discuss (i) the role of foreign commercial borrowing in the financing of the public sector deficit which would still be around 8 percent of GDP in 1992 and (ii) the assessment of macro-economic performance. On the first issue, Mr. Fisher indicated that the IM did not clearly specify how commercial foreign borrowing and domestic bank financing would decline as a result of the adjustment program. The Region responded that the decline would be significant and that this would be made clear in the President's Report. On the second issue, Mr. Fisher suggested, and the Region agreed, that inflation would be added as one of the variables included in the assessment of macro-economic performance required for the second tranche release.

PLjung
January 19, 1990

900108 07 1.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: January 8, 1990

TO: Operations Committee

FROM: EG Enzo Grilli, Acting Director, EAS

EXTENSION: 78061/2

SUBJECT: SRI LANKA: Economic Restructuring Credit - Initiating Memorandum - Agenda

1. The Operations Committee will meet on Wednesday, January 10, 1990 at 4:00 p.m. in Room E-1243 to discuss the Initiating Memorandum for the Economic Restructuring Credit to Sri Lanka. The document was circulated to you under Mr. Karaosmanoglu's signature on December 13, 1989.

Background

2. The Operations Committee discussed the draft Second Year Policy Framework Paper for Sri Lanka on August 2, 1989. At that time, the country's economy was heading for what best could be described as disaster. The First Year PFP targets had not been met. Foreign exchange reserves were declining and had reached a meagre 3 weeks of imports. The fiscal deficit for 1989 was headed towards 16-17 percent of GDP. The draft Second Year PFP set out an ambitious program comprising quick but significant stabilization measures and some structural adjustment measures. At the meeting, the Committee also briefly discussed the proposed Economic Restructuring Credit (ERC). The Region suggested that the processing of the ERC would be predicated on an agreed short-term program and that it would include conditionalities related to trade, public sector management, tree crops and privatization of bus transport. The Chairman suggested that targeting of subsidy programs should also be considered. The Chairman concluded that the PFP would be forwarded to the Board first after the Government had made a reasonable beginning on the 1989 program.

3. As indicated in the Initiating Memorandum for the ERC (para. 25) the Government took decisive action in August and September last year: (i) it devalued the rupee by 20 percent; (ii) postponed implementation of the costly poverty program; (iii) increased the prices of wheat and petroleum by 20 percent and 25 percent, respectively; (iv) cut non-wage, non-interest current expenditures by 20%; and (v) the Central Bank reduced its financing of the budget deficit. Thus, in early October the PFP was discussed by the Committee of the Whole and the Fund Board approved the PFP and a SAF arrangement.

Issues

4. The proposed ERC is more ambitious than what the Region indicated when the Operations Committee discussed the draft PFP. It would reinforce the stabilization program introduced under the SAF arrangement and initiate what could become quite far reaching structural changes. The proposed reforms include: (i) elimination of subsidies for wheat, rice, fertilizer and transport; (ii) rationalization of major welfare programs through elimination of the mid-day meal program for school children, containment and reshaping of the JSP poverty program and reduction and retargeting of the foodstamp program; (iii) enhancing the efficiency of public investment

and maintenance expenditures; (iv) shrinking and streamlining of the government bureaucracy (including retrenching 80,000-90,000 civil servants); (v) large scale privatization of bus transport, management (and possibly ownership) of tea estates, and miscellaneous other government undertakings in fertilizer and paddy marketing and in manufacturing; (vi) continued tariff reform. It can reasonably be argued that this program--and the forthcoming Public Enterprise Restructuring Project--might lead to a much more dramatic policy shift than the liberalization initiated in 1977. However, the ERC is heavily front loaded with stabilization measures centering on expenditure control. The adjustment measures are less concrete and would often not come into full force until after the second tranche release. Thus, the benefits of accelerated growth and increased private sector employment are not likely to materialize for several years. As discussed in Mr. Karaosmanoglu's covering memo (paras. 2-5) these reforms will have to be carried out in a situation of continued political turmoil. The stabilization program will have, at lease in the short term, a major negative impact not only on the poor but also the broad middle class (with the lower middle class probably being hurt the most). Finally, many of the expenditure measures are inconsistent with the election platform that brought the Premadasa Administration into power a year ago. Against this background, the Committee might want to consider the following issues:

* <u>The sustainability of the adjustment program</u>. The first round of policy changes that took place in August and September (see para. 3 above) can be interpreted as the desperate acts of a government trying to avert economic disaster. However, the toughest stabilization measures--and the real pain for the middle class--still lie ahead. Thus, the success of the stabilization and adjustment program depends critically on the Government's continued commitment to its policies and on quick economic payoffs. In order to judge the sustainability of reforms, the Committee might ask the Region to describe (a) the initial results of the stabilization program and (b) what additional actions the Government has taken recently under the SAF arrangement and in preparation of the ERC.

* <u>Realism of economic projections</u>. The program assumes an acceleration of GDP growth from 2.0 percent in 1989 to 4.0 percent in 1992, a compound export growth rate of almost 12 percent over the same period and significant declines in budget and current account deficits. Since the security situation appears to have had a major impact on paddy production, and on tea and other exports in 1989, the Region might want to explain the rationale for these projections. The Region might also discuss the risk associated with a slower response to the adjustment program--especially in terms of the potential impact on the balance of payment and the financing gap.

* <u>Social impact</u>. While many of the reforms--public sector retrenchment, price increases and abolishment or retargeting of major welfare programs--will affect primarily the middle (especially the lower middle) income groups, the poor will also see their cost of living increased significantly (IM pages 42-43). The Committee might want to consider the possibility of improving

the safety net for the poor by, for example, expanding the nutrition pilot program, and accelerating the processing of the proposed poverty alleviation project. The Region might also want to elaborate on the additional analyses of the ERC's social impact that will be undertaken during appraisal.

* <u>Timing and feasibility of administrative and enterprise reforms</u>. About one seventh of all civil servants would be retrenched over a 3-4 year period. About one-quarter of this retrenchment would take place before the second tranche release. The Region might want to explain the procedures that will be followed during the retrenchment process. The Government has also decided, in principle, to privatize the Ceylon Transport Board (with 52,000 employees) and the tea estates. It is clear (from para. 37 of the IM) that the Region has some doubts about both the feasibility of quickly implementing these reforms and the soundness of the proposed privatization approaches. After the Region has elaborated on the privatization proposals, the Committee might want to discuss the trade-off between the political imperative of moving quickly on privatization and the need to undertake more elaborate analyses of possible options.

* <u>Risks</u>. As clearly described in the covering memo, the risks associated with the proposed ERC are considerable. In assessing the ERC, however, the Committee might also want to consider what could happen to Sri Lanka's economy--and to the Bank--if we did not support the Government's economic program.

<u>OC Members</u>

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Wapenhans, Rajagopalan
Fischer, Shihata, Kashiwaya, Wood, Vergin.

cc: Messrs. Lee (COD); Shakow (SPR); Holsen (CEC); Rao, (FRS); Bock (CFS), Burmester/Thahane (SEC); Goldberg (LEGOP), (Ms.) Okonjo-Iweala (OPNSV); Thalwitz (PPRSV); Parmar (IFC-CIO), Linn (IEC), Kavalsky (FRM); Pfeffermann (IFC-CEI); Liebenthal (SPRPA), Kilby (FRS), Robless (OPNSV); (Ms.) Haug, Khanna (EXC); Yenal, Asanuma, Clift, Huang, Zagha, ASI.

PLjung:vlw

January 5, 1990

90012018 2.

THE WORLD BANK

Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee to Consider the

The Social Dimensions of Adjustment (SDA) Program; Africa Region

Held on Friday, January 5, 1990, at 4:00 p. m. in Room E1243

A. Present

Committee

Messrs. M. A. Qureshi, Chairman
I. F. I. Shihata, LEGVP
V. Rajagopalan, PREVP
/S Fischer, DECVP
E. V. K. Jaycox, AFRVP
D. C. Rao, FRS
A. Golan, ASI
E. F. Lari, EMN
A. M. Choksi, LAC
H. Vergin, OPNSV

Others

Messrs./Mmes I. Serageldin, AF1DR
H. Wyss, AFTDR
A. Rigo, LEGAF
E. R. Grilli, EAS
F. S. O'Brien, AFRVP
S. M. Denning, AFRVP
M. Noel, AF1DR
M. E. Tadros, AF1SD
R. L. P. Harris, CODOP
D. J. Casley, CODMO
R. B. Liebenthal, SPRPA
N. Okonjo-Iweala, OPNSV
J. D. Shilling, CFS
P. J. Dufour, FRM

B. Issues

1. The Committee followed the Agenda prepared by EAS.

Evolution, Priority Objectives and Expected Output of the Program

2. The Chairman opened the discussion by saying that the SDA Policy Agenda paper was a well written document which could nonetheless benefit from additional reference to country examples and lessons of experiences gained to date. He noted that no decisions were to be taken by the Committee on the SDA program, but that it was important to establish a better understanding of how SDA had evolved, the extent of its present activities and next steps. He invited the Region to explain the processes by which priorities are established, countries are selected, resources contributed by donors are allocated. He also invited the Region to explain what were the preferences of bilateral donors, the composition of trust funds and the SDA work program.

3. The Region noted that it had spearheaded the SDA initiative and introduced it in order to ensure the political sustainability of adjustment programs without compromising on the substance of such

programs; thus ensuring growth with equity. The SDA program is intended to measure the social costs of adjustment, which have to be compared with the social costs of non-adjustment and the social consequences of Government action or lack of it. The Region emphasized that the SDA initiative is essential to obtain bilateral donors support for the Special Program of Assistance (SPA) for Debt Distressed Low-Income Sub-Saharan Countries. Donors are partners with the Africa Region in the SDA and SPA programs. In the Africa Region, SDA is woven into country assistance strategies in general and structural adjustment programs in particular.

4. The SDA project has evolved substantially since its inception in July 1987. Originally, the SDA program was to be limited to 10 Sub-Saharan African countries; the number of countries now seeking SDA assistance has reached 28. SDA was originally sponsored by three agencies (AfDB, UNDP and The World Bank), now SDA is being supported by more than ten donors. The scope and objectives of SDA -- which consisted originally of survey work, country studies and cross country comparisons -- have expanded to give greater attention to incorporating social dimensions considerations more broadly into country strategies and implementation during adjustment.

5. The Region noted that the SDA Unit is in the process of finalizing a number of methodological and analytical papers designed to improve the understanding and analysis of social dimensions considerations. In particular, a four volume Conceptual Framework Paper has been developed following an extensive process of consultation within the Bank and with UN Agencies, bilateral donors and officials of Sub-Saharan African Countries. This process included seminars and meetings within the Bank and a series of seminars with UN agencies, bilateral donors and African officials in Paris, Arusha, Dakar, Washington and Yaounde. Through this process a general consensus has been built on the approach proposed in the Conceptual Framework Paper, which the Region plans to process to Grey Cover stage in due course. In addition, seven detailed Analysis Plans on particular topics of concern are being developed to provide prototype guidelines for data analysis. An SDA Regional Training Program has also been developed to complement specific training programs designed at the country level.

6. A member of the Committee wondered why the OC was discussing the SDA program, since it appeared to be a way of raising resources for purposes normally supported by the Bank. A member commented that the SDA should be a general concern of the Bank and not be limited to a Region or a separate project. Another speaker asked how did the program differ from what the Bank does in the social sectors. The Region noted that the SDA initiative had a rather specific history and motivation. It was in this sense a response to the accusation that the Bank was "rending the social fabric of African countries" through its structural adjustment programs. Hence its emphasis on Africa, where the social fabric is particularly vulnerable. More generally, the SDA program was launched to integrate social concerns into macro and sectoral policies more concretely and systematically than it was done till then. Finally, a specific SDA structure was justified because of the large amounts of donor resources being applied to the program and the need to ensure proper management and scrutiny by the Bank.

7. Several speakers expressed appreciation for the SDA Policy Agenda prepared by the Region, which they found well written and clear. However, some of them noted that on the basis of the document it was hard to discern what exactly the SDA program had delivered and how resources had been used. Furthermore, in the view of some speakers the program appeared to be very ambitious, but not yet clearly prioritized. It was suggested that the Document include more country references and be more focussed on the experiences gained in the design and implementation of SDA-type projects. Greater country specificity on the content of the appraisals would also make the document more persuasive with donors. The Region agreed that the Policy Agenda would benefit from additional country examples and undertook to add such references to the document before its ultimate publication. The Region, however, felt that it was premature to attempt to evaluate its experience with the implementation of SDA-type projects. Not enough experience has been gained so far to make an evaluation meangingful and generally useful. The Region also pointed out that the program had grown in size, but that this was a reflection of the strong support that it found in donors and of the size of the problem being dealt with. Detailed accounts of activities (country and regional) and work plans were contained in other documents of the SDA project unit, which were available.

8. A member of the Committee stated that SDA's approach to data collection appeared to be over-ambitious. The Region indicated that the data requirements of the program were a function of its nature: a mechanism to help the Country and the Region identify in a <u>systematic</u> way the areas of social policies and actions required to ensure sustainability of adjustment programs.

9. On the question of use of SDA resources, the Region indicated that about $7.5 million have been spent so far. This amount covers all aspects of the SDA program including the cost of preparing and developing the conceptual framework and analytical work, convening of seminars, development of Regional Training program, country assessment papers, identification, preparation and appraisal of projects in 14 countries.

10. On accountability, the Region noted that the SDA work program, including its financing, is reviewed by an SDA Steering Committee, which is composed of the three co-sponsoring agencies, other UN agencies and the contributing bilateral donors. The meetings of the Steering Committee are planned to coincide with SPA meetings whenever possible. In addition, a Bank-wide SDA Project Management Committee reviews the SDA work program and provides guidance and advice to the SDA Unit.

<u>Coordination Within the Bank</u>

11. In response to a question about access to data, the Region agreed that in principle access to data should be open. However, Government sensitivities on this issue should also be kept in mind. At present, Governments tend to be cautious about data access. The Region stated that it hoped to obtain Governments' agreement for some further liberalization of access to data. It noted that data generated by SDA will contribute significantly to the data base in Sub-Saharan Africa. Data access procedures within the Bank have been agreed between the Region and PPR. It was also noted that recent progress has been made to

further the collaboration between PPR and the Region on SDA activities. A Committee member noted that while SDA had taken a proprietary attitude to data in the past, progress was being made. He urged the Region to be more aggressive vis-a-vis governments in this respect.

12. The Region will take advantage of the fine-tuning exercise to restructure SDA within the Region. The Region is currently designing the new structure of SDA which will ensure that SDA be fully integrated within the Regional structure and country assistance strategy. At present, it is envisaged that a core SDA Unit will be located in the Technical Department and other SDA staff resources will be allocated to Country Departments according to the CAMs.

Countries and Project Concerns

13. In response to a question concerning the scope of country activities under SDA as presented in Chapter 2 of the SDA Policy Agenda, the Region explained that the model presented in this paper includes: (a) improved macro and sectoral policy management; (b) social action programs for helping vulnerable socio-economic groups; (c) strengthened national information systems for enhanced policy and program formulation; and (d) institutional building and training to support the above three components. The Region emphasized, however, that SDA country activities are "demand-driven": not all countries have all components, some countries move faster in certain areas than others. SDA projects are designed as part of the country strategy with the full involvement of the country teams and the Governments concerned. SDA projects are either components of SALs, SECAL's, technical assistance and social sectors operations (e.g. Senegal, Mozambique, Chad and Somalia) or self-standing operations (e.g. Guinea and Cameroon). SDA projects have adopted a flexible modular approach in designing project components to respond to specific socio-economic and institutional circumstances of participating countries.

14. At the country level, SDA type projects have been appraised in 14 countries and are effective in seven countries. On average, SDA projects have been appraised at the rate of two per quarter. At this rate, appraisals of the remaining 14 countries will continue until mid FY92. Overall, the SDA Program has developed an accepted approach and with appraisal of 14 countries completed, the SDA initiative is close to the mid-point of its target. In fact, some impact is already beginning to be felt in some countries.

15. The Region noted that an area of concern is the design of SDA type projects. All efforts will be made to avoid "Christmas tree" type projects. At present, SDA type projects resemble the evolution of early urban development projects. The Region is experimenting with different types of projects and will learn from these experiences.

Coordination With Donors

16. Responding to a question on the types of contribution by donors, the Region clarified that donors contribute to the SDA initiative at two levels. First, at the Regional level donors contributed to support of the SDA Unit. These regional contributions complement the resources originally provided by the three sponsoring

agencies. It was noted that the Federal Republic of Germany, through the Munich Center for Applied Statistical Training, is supporting along with other donors the SDA Regional Training Program which has been recently developed. Second, at the country level, donors contribute to co-financing of SDA projects in given countries. Country level contributions are earmarked by donors for specific countries. SDA staff has been very successful in mobilizing resources at both levels.

17. The Region noted that donor support to SDA has been more than originally anticipated. Donors wish to get involved as partners; SDA has provided such an opportunity. In response to a question, the Region indicated that the issue of Trust Funds was raised as an issue for the Bank as a whole and not specifically for SDA Trust Funds. Finally, the Region stated that the Document being discussed was not intended to be used as a basis for mobilizing additional funds at this stage. New fund raising will in the future be subject to Bank-wide coordination under the new procedures.

Conclusion

18. The Chairman concluded by saying that the SDA paper was well written, but should provide more concrete examples and discuss the experience and approach to integrating SDA into the mainstream of the Bank's work. He also noted that it was important to put SDA in perspective. While the proposed approach may look ambitious, it should be recalled that the Bank had been criticized in the past for being totally insensitive to the poor in structural adjustment programs. The SDA Policy Agenda clearly describes how the Bank has, in the past, worked to alleviate poverty through parallel programs, e.g., PAMSCAD in Ghana. SDA is now working to treat social concerns as an integrated component of the adjustment programs themselves. The paper is trying to define the areas which should be integrated with adjustment programs. The Chairman noted that the Africa Region had exploited a good opportunity to draw in donors resources and support for a worthwhile cause. It is very important to plan how we move with SDA from here in order to maintain the momentum of the progress already achieved.

METadros/ERGrilli:sb

January 12, 1990

Ms. Okonjo - Iweala

January 11, 1990

Mr. D.C. Rao

Re: Draft Minutes of OC Meeting on SDA

I take notice of your concerns on the draft minutes, which I will try to reflect in the final draft, particularly the points that you made on para. 2. I find it a bit more difficult to reflect your comments of the apparent shortcomings of the draft in the minutes (para 1), since they are judgmental in nature and have to do with what you would have liked the document to be. Para. 3 will be incorporated.

Finally, you know very well that it is not a normal practice for the minutes to be written by Regional staff. We try to minimize these occurrences, but sometimes they cannot be avoided because of EAS staff shortages. Yet, I don't see the point of your remarks on who wrote the first draft, since the review process is intended to provide everybody with an opportunity to suggest integrations and changes to the first drafts and to keep the process open and efficient. In the final analysis, EAS takes responsibility for the drafts and Moeen clears them. It is the final product that counts, not the first draft.

As a postscript, I am sorry to notice that you found it necessary to copy your comments on the draft minutes to the OC members.

Enzo

Enzo Grilli

cc: Messrs. Wood, Dubey (o/r)

EGrilli:pl

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

891226004

1.

DATE: December 21, 1989

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

VDubey

EXTENSION: 78051

SUBJECT: Social Dimensions of Adjustment Project; Africa Region

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1. The Operations Committee will meet on January 5, 1990, at 4:00 p.m. in Room E1243 to consider the Social Dimensions of Adjustment (SDA) Project of the Africa Region. The following represents a proposed agenda.

Background

2. Initiated in 1987, the SDA Project is jointly sponsored by the UNDP Regional Program in Africa, the African Development Bank, and the World Bank, with the World Bank as the Executing Agency. The Project is designed to help governments in Sub-Saharan Africa to integrate the social dimensions in their structural adjustment programs and development plans. Twenty-seven countries in Sub-Saharan Africa have requested to participate in the Project. To date, projects have been appraised for 14 countries. A table is attached giving the status of the funding of the Project, by source, by Regional activities, and by country specific projects (see attachment).

24 Countries requested
14 Countries appraised
7 Effection
12 Countries

Issues:

Evolution, Priority Objectives and Expected Output of the Project

3. The Committee may wish to ask the Region to provide a background on the evolution, major priorities, and the expected outputs of the Project. In particular, the Region may wish to elaborate on the following:

- Project Evolution. How has the Project evolved into its present form and size and how has this evolution affected the nature of the objectives and planned outputs of the Project?

?

- Priority Objectives. As of the present, what are the major objectives of the Project? What is the relative priority attached to the preparation of Bank lending operations related to the social dimensions of adjustment; to country assistance in support of capacity-building for analysis and program formulation; to training; and to statistical data generation? To what extent does the allocation of funding

Relative Priority? the various activities -
Varies from country to country

Integrated poverty reduction

Guinea
Cameroon

and staff resources reflect the priorities of the Project? What is the relative weight attached to regional in contrast to country-specific issues in these objectives?

Regional vs Country Specific

- Life and Expected Outputs. What is the project life and how does this relate to the expected outputs of the Project? What is the expectation of the Project as to the output in terms of policy advice and technical assistance; preparation of projects for financing; research and operational methodology; and statistical data generation? To what extent would this lead towards internalizing the work both in the Bank's operational units and in the country governments?

Project life ? Expected output within time

Coordination within the Bank

4. The Committee may wish to ask the Region to elaborate on the nature and manner of involvement of the different units in the Bank which are working substantially on issues of social aspects of adjustment, in particular, to the following:

- To what extent should the operational objectives of the Project be carried out or integrated within the operating units of the Bank, specifically at the country level?

- How does the Project draw upon the expertise available in other parts of the Bank with a substantive interest on the issue of social aspects of adjustment?

- To what extent does the broad-ranging mandate of the Project provide competition or displacement with other on-going activity within the Bank, for instance, the living standards surveys that have been undertaken for some African countries?

Coordination with Country Concerns

5. The Committee may want to ask the Region how the Project accomodates the concerns and priorities expressed by the countries that are acceding to the SDA Project. In particular, the Region may want to elaborate on the process by which a country joins the Project. What are the expectations of the country and of the Region, and how does the Project accommodate the expressed priorities and concerns of the country?

6. The Committee may further ask the Region whether the priorities of the Project could alter country priorities in unintended ways and to what extent safeguards are therefore put in place in order to avoid these adverse results. For instance, could the immediate concerns with the social dimensions not be excessive relative to the other aspects of adjustment programs? This could be counterproductive and may eventually result in an unfavorable impact on the social costs of

What has been the experience

Are we getting to the stage that we may want to have our cake and eat it too - Impossible expectations

Papers/talks of broader ?

adjustment. At another level, how do the data gathering/survey concerns affect the overall statistical programs and priorities being developed within the country? Could there be a case of crowding out other desirable data gathering activities -- for instance, periodic surveys and censuses -- given the application of resources to the data generation needs of the Project?

Coordination with Donors

7. The Committee may want to be apprised by the Region about the expectations entertained by the donors concerning the Project. The Region may further explain the division of labor among the donors and cosponsors and the extent to which conflicts of jurisdictions and concerns have arisen and how they are to be settled. To what extent does the presence of a large number of cosponsors complicate the Project? Would there be a case for redefining outputs in the Project so that cofinanciers can focus on their expectations on those outputs?

cc: Messrs./Mmes Qureshi, Shihata, Wood, Rajagopalan/Fischer, Kashiwaya, Jaycox, Karaosmanoglu, Wapenhans, Husain, Vergin, Serageldin, Goldberg, Lee, Shakow, Holsen, Bock, Burmester/Thahane, Noel, Okonjo-Iweala

For Information Only

cc: Messrs./Mmes Thalwitz, Parmar, Pfeffermann, Linn, Kavalsky, Haug, Liebenthal, Kilby, Challa, Robless/Lawrence, Khanna, Agarwala

GSicat

Attachment

Traded Ned 200,000

Table I

overhead from the Bank
Visit the Country
Prepare the project

SDA Unit
Donor Funding Status

Source	Regional Activities	SDA Country Specific Projects
EFFECTIVE		
UNDP*	US$5.0 million	US$1.6 million for Madagascar
AfDB	US$2.5 million including the secondment of a Senior Economist for the SDA Project Unit.	US$2.5 million for Gambia US$1.9 million for Guinea US$1.7 million for Malawi
World Bank (Executing Agency)	US$2.5 million in kind. Cen $5 + Secretariat Staff	T.A Econ. Mgmt. US$3.0 million for Senegal US$9.0 million for Guinea US$1.2 million for Chad US$20.0 million for Cameroon US$0.9 million for Madagascar US$1.1 million for Côte d'Ivoire
Norway	About US$0.8 million equivalent and a secondment of a Statistician to the SDA Project Unit for two years.	US$2.7 million for Zambia.
Canada	US$1.0 million equivalent for 1988/89.	US$2.0 million for Senegal. US$0.8 million for Guinea.
Switzerland	About US$1.3 million and a secondment of a Senior Economist to the SDA Project Unit for three years.	US$1.5 million for Chad and cofinancing of SDA projects in Mozambique and Ghana.
F.R. of Germany	About DM1.0 million (US$0.6 million equivalent) for regional training through the Munich Center for Advanced Training in Applied Statistics for developing countries.	About DM4.0 million (US$2.5 million equivalent) for cofinancing SDA projects in selected countries, e.g. Ghana, Mozambique and Malawi.
European Communities	Secondment of a Senior Economist to the SDA Project Unit for two years and hosting of the Statistical Advisory Committee meetings.	Cofinancing of SDA projects in countries to be determined e.g. Cote d'Ivoire, Togo and Mozambique, Malawi and Somalia.

* UNDP has the leadership for SDA initiatives in Tanzania and Niger.

IFAD	US$100,000 cash contribution and in-kind contribution through IFAD study on Impact of Structural Adjustment on small-holder farmers, and the Analysis Plan for Smallholders.	Cofinancing of SDA Projects in countries to be identified.
Sweden	About US$2.20 million.	About US$4.3 million for cofinancing SDA Projects in specific countries e.g. Mozambique, Somalia and Tanzania.
EXPECTED		
Canada (II)	About US$2.6 million.	Cofinancing of projects in specific countries.
The Netherlands	Establishment of an SDA Trust Fund and secondment of a macro-economist.	Co-financing projects in selected countries, e.g. Mozambique and Tanzania.
Norway (II)	About US$0.7 million.	Cofinancing of projects in specific countries.
UK (ODA)	Secondment of a Social Policy Specialist.	Cofinancing of projects in selected countries, e.g., Ghana, Malawi, Mozambique and Zambia.
USAID		Cofinancing of projects in selected countries, e.g., Mauritania, Ghana and Malawi.

Qureshi
E1241

January 3, 1990

89122 6001 1.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 22, 1989

TO: Operations Committee

FROM: Edward V.K. Jaycox, AFRVP 12/22

EXTENSION: 34400

SUBJECT: **Capacity Building Initiative: A Framework for Capacity Building in Policy Analysis and Economic Management in Sub-Saharan Africa**

The Operations Committee will meet on Wednesday, January 3, 1990 at 4:30 p.m. in Room E-1243 to discuss the African Capacity Building Initiative paper (ACBI). The paper is intended to provide a broad framework for a new partnership between Africans and donors to invest in human capital and institutions. It is not a detailed appraisal document but a framework for careful coordination and synchronization of various on-going activities. The following represents a proposed agenda for the meeting.

1. <u>Is it a Priority Initiative?</u>

Indigenous skills, effective institutions and resources are lacking in virtually every sector of African economy. The shortage of these local capacities is one of the major causes of the economic problems that now face Sub-Saharan Africa. Poor policies and weak economic management have combined with external factors to bring many countries of the region to a state of crisis. Hence, if Africa is to achieve sustainable human and economic progress, capacities must steadily and systematically be built in individuals, groups and institutions that will support and sustain policy reforms.

- The Committee may want to discuss whether the paper has identified a priority issue for the Africa Region, and also whether it has provided adequate rationale for the Initiative.

2. <u>Proposed Action Program</u>

The Capacity Building Initiative is aimed at increasing policy analysis and economic management capacity and also at improving the use of existing capacity. The program should result in the provision of high-quality indigenous policy advice to African decision-makers; the training of economic managers and policy analysts in the public and private sectors; an increase in reliable sources of research and information; and an improvement in the policy dialogue on issues of significant economic importance for individual countries and the region as a whole.

- The Committee may want to discuss whether the proposed program components are the right ones, and whether they provide the correct balance in priority areas, and what value-added they would bring to on-going donor support for institutional development in Sub-Saharan Africa.

3. Mechanisms for Implementation

In order to implement the activities proposed in the previous section on a sustainable basis, a number of conditions must be satisfied. First, donors must recognize the value of better coordination in implementing their current activities. Second, additional resources need to be mobilized to meet a variety of country-and regional-specific requirements in a responsive, flexible, and cost-effective fashion. Third, broad participation and firm commitment by donors and African governments are essential to sustain this effort over the longer term.

- The Committee may want to discuss whether the mechanisms proposed in the paper to help effect coordination and to mobilize resources are appropriate, flexible and feasible. Can the proposed administrative arrangements provide sufficient checks and balances?

4. The Role of the Bank

The Bank has undertaken intensive and extensive consultations with Africans, donors and major foundations on this initiative. There has also been close collaboration with the African Development Bank and the UNDP in developing the ideas in the paper.

- The Committee might wish to focus on the role of the Bank (financial and managerial) in implementing the initiative.

What is the comparative advantage?

December 22, 1989

89121801 4 1.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: December 18, 1989

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXTENSION: 78051

SUBJECT: Review of Country Lending Programs for FY91-93

The Operations Committee will meet to discuss the above paper on Friday, December 22 at 11 a.m. in Room E-1243. The paper is being distributed by Mr. Vergin's office.

Operations Committee

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Lari, Shihata, Kashiwaya, Fischer/Rajagopalan, Wood, Vergin

cc: Messrs./Mmes Lee, Shakow, Holsen, Rao, Bock, Burmester/Thahane, Goldberg, Okonjo-Iweala, Thalwitz, Parmar, Linn, Kavalsky, Pfeffermann, Liebenthal, Kilby, Robless, Haug, Khanna,

/eg

become more competition

Thank the Bank,

Do not have other alternative

Have now the basis to accelerate the

Put accent — on suppression in certain reform. [illegible]

Social Dimension of Adjustment.

President has charged him.

reform in public sector — can now

reform in agri sector — Commit

Private Sector should play a

bigger role

Caisse Stab — should control -

Put in Place a plan for

the Pub Sector Societies

2nd tranche of 2nd SAL

Start 3rd SAL

THE WORLD BANK
INTERNATIONAL FINANCE CORPORATION
MULTILATERAL INVESTMENT GUARANTEE AGENCY

Liquidity.

Program will be delayed.
2nd tranche of the 2nd SAL
3rd SAL. — no gap.

November 29, 1989

MAQ 2
89120107

THE WORLD BANK
OPERATIONS COMMITTEE

Minutes of the Operations Committee to Consider
REPUBLIC OF COTE D'IVOIRE - Energy Sector Adjustment Loan (ESAL)
Grey Cover President's Report

Held on Wednesday, November 29, 1989, in Conference Room E1243

A. Present

Committee	Others
Messrs. A. Karaosmanoglu, Chairman	Messrs/Mmes V. Dubey, EAS
S. Fisher, PPRVP	E. Grilli, EAS
E. K. Jaycox, AFRVP	P. Ljung, EAS
H. Scott, LEGVP	I. Serageldin, AF1DR
H. Vergin, OPNSV	R. Westebbe, AF1DR
E. Lari, EMNVP	C. Poortman, AF1IE
D.C. Rao, FRS	J. Bond, AF1IE
	M. Wilton, AF1IE
	P. Landell-Mills, AF1CO
	F. Kaps, AF1CO
	M. Guerard, AFRCE
	J. Reitmaier, IMF
	P. Lazar, IMF
	F. Earwaker, SPRPA
	A. Steer, DECVP
	R. McPheeters, FRS
	M. Boucher, CFSFA
	A. Khanna, EXC
	A. Heron, COD

B. Issues

1. Given the uncertainties inherent in the Ivorian Government's recent moves to deal with the serious macro-economic situation, the OC had decided--when reviewing the Agricultural Sector Adjustment Operation (ASAL) on August 29, 1989 --that the Grey Cover Packages for the Energy and Water Sector Operations would be considered separately by the OC before being submitted to the Board. In opening the discussion, the Chairman referred to the decision by the President that the processing of these operations should await: (i) further progress on the implementation of the Government's current program; (ii) mobilization of adequate financing for Cote d'Ivoire; and (iii) agreement with the IMF on additional measures that were needed to establish a viable medium-term framework. The discussion broadly followed the agenda prepared by EAS.

2. The Region explained that the Government had scrupulously fulfilled all the requirements for the Fund Stand-by and the ASAL. In some cases, the

Government had even gone further than what it had agreed to, for example, when world market prices continued to weaken, it had reduced guaranteed producer prices for coffee and cocoa to CFAF 200/kg rather than to CFAF 250/kg as agreed under the ASAL. The Government had also moved expediently to implement the initial reforms in the energy sector. The OC generally noted with satisfaction the significant policy movement taking place in Cote d'Ivoire. Thus, there was a consensus that sufficient progress had been made on the current short term program.

3. As regards the financing program, the Region explained that it was essentially the same as the program outlined under the Fund's Stand-by Agreement, which had been approved on November 20, 1989. It was based on commitments made at the October 9-10, 1989 aid group meeting. The restructuring/rescheduling assumptions given in the ESAL document were consistent with the Fund assumptions and with past experiences. Furthermore, the new Finance Minister had met on November 9-10, 1989 with the Steering Committee of the commercial banks and had made specific proposals for the restructuring of Cote d'Ivoire's commercial bank debt. He had also indicated the Government's willingness to resume some debt service payments as early as 1990 (after a hiatus of about three years). The commercial banks were presently studying the proposal and another meeting was expected not later than early January, 1990. The IMF representative noted that the framework agreement with the commercial banks would probably be reached within a reasonable period of time, but definitely well before the SBA expires in April 1991. The implementation would take some additional time. A meeting of the Paris Club was expected in December or early next year. The Region stated, however, that the financing plan might unravel if the Bank did not approve all three adjustment operations in a timely fashion. After a brief discussion, the OC agreed to go ahead on this basis.

4. The medium-term framework was the main topic of discussion. Several members noted that a real devaluation of at least 25 percent was needed to restore Cote d'Ivoire's international competitiveness. However, given the implications going beyond Cote d'Ivoire, a nominal devaluation was presently ruled out by the Government. Consequently, the real devaluation would primarily have to be achieved through large reductions in nominal wages and, thus, it would be associated with a prolonged period of declining real consumption levels. The political feasibility of such a scenario was questioned. Several speakers also expressed doubts about whether the proposed measures--i.e. regulatory reform, rehabilitation and/or privatization of public enterprises, tax and tariff reform and reduction in government spending (especially cuts in the wage bill)--would be sufficient to achieve a real devaluation of the magnitude needed. The Region explained that the elaboration of the medium-term plan had only been going on for a couple of months. What existed so far was only a broad framework outlining the areas of reform but not the details and timing of the required policy actions. However, the broad outline of this framework had been agreed with the Fund before the Stand-by had been finalized. The key steps needed to develop the framework into an action program (i.e. studies of public expenditures, resource mobilization and international competitiveness) had been agreed with the Government. Furthermore, the Government was aware of the likely social and economic implications of the selected route of reform and, if it did not yield the expected results, of the potential need for a nominal devaluation in the

future. The Region also explained that senior management of the Bank and the Fund had met in early October with Minister Koffi--at the time Minister of Budget, but subsequently entrusted with the portfolios of Economy, Finance and Budget. The understanding they had reached was as follows: the Phase I program (1989-90) would be supported through the three SECALs provided that (i) the Bank and the Fund agreed on the overall medium-term framework and (ii) the Government was making serious progress on the definition of the detailed Phase II (i.e. medium-term) program. Bank financing of the Phase II program would be contingent on the Government's commitment to the necessary medium-term actions in a timely manner. The IMF representative noted that this was indeed consistent with the Fund's approach. The OC, however, saw a need to take reasonable action to ensure that the Government would indeed take the appropriate steps to define and implement the required medium-term policy actions. Given the fact that the Loan had already been negotiated, this should be done through a letter to the Government (see para. 6 below).

5. The OC agreed that the policy and institutional actions proposed under the ESAL were sound and would achieve significant results in improving sector performance. They were also consistent with the overall strategy of reducing domestic costs to enhance Cote d'Ivoire's competitiveness. In this connection, however, several speakers questioned the fact that the Energy Policy Statement provided by the Government was one and a half year old and not fully consistent with the Bank sponsored program. The Region explained that the Policy Statement had been prepared at the time when the African Development Bank had negotiated its energy sector loan in mid-1988. Since the main thrust of the Policy Statement coincided with the objectives of the Bank loan, the OC concurred that it was sufficient to just up-date the Policy Statement through the Action Program which had been agreed with the Government and was part of the Loan Agreement.

C. <u>Decision</u>

6. In concluding the meeting, the Chairman noted that a consensus had emerged. The Government of Cote d'Ivoire had made significant policy moves and, in the short-term, support by the Bank, the Fund, other multilateral and bilateral donors and the commercial banks were all needed. However, the medium and long term prospects were still clouded. Thus, the Government should be apprised of the Bank's serious concerns so as to ensure that, as far as possible, a viable medium-term framework is put in place and the risk concerning the Bank's exposure be limited. Thus, he approved the ESAL documents for submission to the Board, subject to the following:

(i) the Region would write "unilaterally" a letter to the Government referring to Article 4.01 of the Loan Agreement and explaining that our continued support under this operation would be linked to satisfactory progress on the formulation and preparations towards the implementation of a viable medium-term policy framework;

(ii) the presentation in the President's Report would be revised to (a) reflect that the medium-term framework had been agreed upon with the IMF, (b) explain that this framework--and its broad implications--had been discussed with the Government and that an agreement had been reached on the specific actions needed to develop it over time, i.e., the next 12 months, into a concrete, viable program, (c) record more explicitly the recent policy decisions taken by the Government, and (d) describe the progress in the Government's discussions with the London Club.

7. The Chairman also noted that no new conditionality would be introduced in the Water Sector Adjustment Operation. However, when that operation goes to the Board, the Region has to be able to report further progress on the preparation of the Phase II medium-term framework.

PLjung:vl
November 30, 1989

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

891127012

Mr. Qureshi 2,

DATE: November 27, 1989

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXTENSION: 78051/2

SUBJECT: COTE D'IVOIRE: Energy Sector Adjustment Operation - Agenda

1. A meeting of the Operations Committee will be held on Wednesday, November 29 at 3:00 p.m. in Room E-1243 to discuss the Grey Cover package President's Report for the Energy Sector Adjustment Operation for Cote d'Ivoire.

Background

2. An Initiating Memorandum for the proposed operation was discussed by the Committee on November 16, 1987; the Green Cover package was circulated in April 1988, and written comments received at that time have been taken into consideration in the further processing of the operation. As you recall, the Energy Sector Operation (ESAL) is part of a package of three sector adjustment operations. The Agricultural Sector Adjustment Operation (ASAL) was approved by the Board on October 24, 1989--after an extensive discussion that centered around the viability of the operation and of Cote d'Ivoire's medium-term prospects in the absence of a real devaluation. The Water Sector Adjustment Loan (WASAL) is likely to be presented to the Board early next year.

3. The Operations Committee discussed the Country Strategy Paper on August 4, 1989 and a revised version was circulated before the Committee's discussion of the ASAL Grey Cover package on August 29, 1989.

4. As noted in Mr. Serageldin's covering memo, in clearing the Board package for the ASAL, Mr. Conable noted that processing of forthcoming SECALs should await: (i) further progress on the implementation of the Government's current program; (ii) mobilization of adequate financing for Cote d'Ivoire; and (iii) agreement on additional measures that were needed to establish a viable medium-term framework. For the ASAL, he also noted that the Board documents should fully explain why the Bank feels justified in proceeding with the ASAL despite the lack of a viable medium-term framework.

5. Against this background, the Committee may want to discuss the broader issues set out in paras. 6-8 and the specific questions raised in paras. 9-11.

Progress on Adjustment Program

6. The Region notes that the Government has scrupulously fulfilled all requirements for the Fund Stand-by and the ASAL. In para. 7 of the covering memo, the Region also notes recent actions taken on energy sector reforms. Do these actions provide a sufficient step forward in the adjustment process to justify the present timing of the ESAL?

Mobilization of External Financing

7. The financing gap of about US$413 million was supposedly filled through additional commitments at the October 9-10, 1989 donors' meeting. However, the financing plan also calls for US$2.9 billion in debt relief from commercial banks and official donors. The bulk of this would come from the London Club members. In view of the recent meeting of the commercial banks' steering committee with the Finance Minister of Cote d'Ivoire, the Region might be requested to present their assessment of the likely outcome of London and Paris Club reschedulings. Since it is anticipated that these debt relief efforts will go well beyond what Cote d'Ivoire has enjoyed in the past, the Committee may want to assess their likelihood and the potential impact on the medium-term program.

Medium-Term Framework

8. Progress on the establishment of a viable medium-term framework is discussed in paras. 9-11 of the covering memo and paras. 26-35 of the President's Report. It is worth noting that the present economic projections differ somewhat from those presented in the ASAL report. (Lower growth 1991-93, higher exports and investments, lower imports.) The Region might be requested to explain the basis for this new scenario. The Committee may want to consider if the emerging policy actions--i.e., regulatory reform, rehabilitation and/or privatization of public enterprises, tax and tariff reform and reductions in Government spending, but excluding a nominal devaluation--are strong enough to restore Cote d'Ivoire's competitiveness when wage rates are nearly double those prevailing in competing countries.

Role of the Energy Sector in the Adjustment Process

9. The ESAL would introduce a new contractual framework for hydrocarbon development; improve investment planning; reorganize and financially restructure key energy parastatals; strengthen the government's policy making and supervision of parastatals; and introduce pricing reforms. The Committee may want to discuss (i) if this package of reforms will have a significant impact on the cost structure of enterprises, on the efficiency of energy use in the economy, on the government budget, and on the balance of payment, and (ii) if the impact of the program is described in sufficient detail in the "Benefits" section (paras. 126-128).

Energy Policy Statement

10. This statement is dated June 1988. While the main thrust is similar to the program supported under the ESAL, there appear to be many discrepancies that go further than just timing. The Committee may want to consider if the Government should be requested to provide a new statement that is fully consistent with the Bank-sponsored program.

Legal Documents

11. While the key conditionality and tranching appear to be properly reflected in the Loan Agreement, the sections on procurement and disbursement in the President's Report are on several points inconsistent with Schedules 1 and 3 of the Loan Agreement.

Operations Committee

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Lari, Rajagopalan, Fischer, Shihata, Kashiwaya, Wood, Vergin.

cc: Messrs. Lee (COD), Shakow (SPR), Holsen (CEC), Rao (FRS), Bock (CFS), Burmester/Thahane (SECGE), Goldberg (LEGOP), (Ms.) Okonjo-Iweala (OPNSV), Thalwitz (PPRSV), Parmar (IFC-CIO), Linn (IEC), Kavalsky (FRM), Pfeffermann (IFC-CEI), Liebenthal (SPRPA), Kilby (FRS), Robless (OPNSV), (Ms.) Haug, Khanna (EXC), Agarwala (AFRCE), Serageldin, Westebbe, Landell-Mills, Poortman, Kaps, AFR.

PLjung:vl

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 21, 1989

TO: Mr. Moeen Qureshi, OPNSV
Through: Mr. E.V.K. Jaycox, RVP, Africa Region
FROM: Mr. Ismail Serageldin, Director, AF1

11/21

EXTENSION: 34502

SUBJECT: COTE D'IVOIRE - Energy Sector Adjustment Loan (ESAL)

OK
11/22

1. Attached for review by the members of the Operations Committee, is the Grey Cover President's Memorandum and related documents for the above operation. This will be the third operation for Côte d'Ivoire during FY90; the Agriculture Sector Adjustment Loan (ASAL) and the Municipal Development Project (MDP) were presented to the Board on October 24, 1989.

2. As you know, these three loans are all part of a package of loans negotiated with the Government of Côte d'Ivoire during the month of July 1989. The ASAL and the ESAL, in particular, are part of the Bank's program of support to Côte d'Ivoire's ongoing adjustment efforts. This program -- which also includes a Water Sector Adjustment Loan (WASAL) -- was reviewed by Mr. Conable in September 1989, after which he instructed the Region that processing of any further SECAL in addition to the ASAL, should await:

(i) mobilization of adequate financing for Côte d'Ivoire;

(ii) discussion of the ASAL by the Board;

(iii) further progress on the implementation of the Government's current program; and

(iv) agreement on the type of additional measures to be taken toward establishing a viable medium-term outlook for Côte d'Ivoire's economy.

In light of events that have taken place since September, as detailed below, we feel that all the above conditions have been fulfilled and the ESAL should now be submitted to the Board as soon as possible. The energy sector reform program would make an important contribution to the Government's financial stabilization efforts and simultaneously enhance the competitiveness of the country's productive sectors.

Recent Events

3. As you know, the OC meeting of August 29, 1989 reviewed the Côte d'Ivoire CSP which had been elaborated by Bank staff in close consultation with the Fund. The CSP discussed the severe macro-economic crisis from which the country is currently suffering, characterized by a sharp decline in its terms of trade and a rapidly falling GDP. The CSP

concluded that there were no substantive prospects for recovery over the medium-term without a real depreciation of the CFAF leading to a realignment of relative prices, but that a number of interim financial measures had to be adopted in order to set the stage for full medium-term adjustment.

4. Since the OC meeting the following important events have taken place:

(a) Based on the stabilization program presented by the Government during a meeting in Paris on October 9-10, the "Friends of Côte d'Ivoire" pledged the equivalent of $450 million of additional financial assistance, thus closing the gap for the 1989/1990 fiscal deficit.

(b) On October 15 Côte d'Ivoire's Cabinet was reshuffled, putting in place a leaner, more efficient, Government with strong commitment to reform. In this reshuffle, Minister Koffi, the previous Minister of Budget who had visited the Bank and Fund in early October as President Houphouet Boigny's special emissary to discuss Côte d'Ivoire's economic recovery program with senior management of the two institutions, was entrusted with the key portfolios of Economy, Finance and Budget, now joined into one Ministry, giving him a clear mandate to take charge of Côte d'Ivoire's economic problems.

(c) On November 9 and 10, Côte d'Ivoire met for the first time since May 1988 with the Steering Committee of its commercial bank creditors. At this meeting, the Minister of Finance made specific proposals for the restructuring of Côte d'Ivoire's commercial bank debt. He also indicated his government's preparedness to resume some debt service payments to the banks as of early 1990. The Steering Committee is currently reviewing these proposals and it was agreed that another meeting would take place in mid-December or early January.

(d) Following the successful outcome of the gap filling exercise referred to under (a) above, the resumption of discussions with the commercial banks, and the adoption of important cost cutting and revenue enhancement measures (discussed in further detail below and in the President's Memorandum), the IMF Board approved on November 20 a stand-by arrangement amounting to SDR 175.8 million -- equivalent to 75% of Côte d'Ivoire's quota -- covering the period July 1, 1989 - December 31, 1990.

(e) The Government has scrupulously fulfilled all requirements and conditions related to the standby arrangement as well as the Bank's ASAL, which became effective on October 25, 1989. Moreover, over the last month it has defined a medium-term adjustment program, with assistance from the Bank and the Fund. The broad outline of the program has been endorsed by the Minister of Finance. It is briefly referred to below and discussed in more detail in the attached President's Report.

5. In total, therefore, we feel that the Government of Côte d'Ivoire has undertaken serious efforts to implement the measures necessary for short-term reforms. More importantly, the Government now appreciates that growth in the medium-term will require, in addition to short-term fiscal and structural reforms, significant additional measures aimed at realigning relative prices in the economy. The Government's strategy is therefore based on a sound two-phase approach: short-term fiscal reforms, and a first series of structural measures, followed by more fundamental adjustment.

Phase I: Short-Term Program

6. The Government's primary objective in the short-term is to move towards public finance equilibrium and reduce domestic payment arrears. Whereas the current phase of measures being implemented does target financial stabilization issues as a first priority, it also includes certain essential sectoral reforms, prepared during the period when the macro-economic dialogue with the Bank was tenuous, which are now being put in place. These reforms aim principally at the restoration of international competitiveness through reductions in factor costs, strengthening of economic incentives, removal of distortions created by government intervention, and increased reliance on the private sector. The first category of these reforms are in the agricultural sector where major policy adjustments have already been implemented as part of the ASAL.

7. In the energy sector, the ESAL, the subject of the attached report, supports the Government's structural reform efforts to: (i) revise the contractual framework for hydrocarbon exploration and development, with a view to greater private sector participation in this activity; (ii) review the energy sector portfolio to define an optimal investment program; (iii) reorganize and financially restructure energy parastatals; and (iv) introduce more efficient--flexible--pricing for energy products, as well as selective energy price reductions. The Government has already moved on several of these fronts:

- the power utility is undergoing the first phase of a financial restructuring program which will be extended over an 18 month period;

- investment studies by the power utility have produced revised investment options featuring: a more rational policy of electrification to ensure that resources are directed to regions where the largest benefits are identified, including external socio-economic benefits for the rural poor; and the use of existing natural gas reserves for power generation;

- a new petroleum exploration/development contract has already been drawn up and its terms are being applied in ongoing discussions with international petroleum companies;

- the petroleum company has been radically restructured involving a change of management and a significant reduction in staffing; and

- the producer price of petroleum products has been revised (as a first step in the revision of the entire price setting mechanism) and the consumer price of selected petroleum products has been reduced.

8. Also as part of the short-term program the Government intends to restructure the water and sanitation sector with a view to reducing and realigning water costs, so as to help improve industrial competitiveness, and protect the environment from the ravages of uncontrolled tapping into ground-water reservoirs. This would be supported by the WASAL scheduled for Board consideration in early 1990.

Phase II: Medium Term Adjustment

9. The success of the short-term program of fiscal and structural reforms is a necessary but not sufficient condition for the resumption of growth. This will require a further shift in relative prices and in the incentives structure in favor of tradable goods, inducing in effect a further depreciation in real terms of the CFAF beyond what the short-term program has achieved. The Government has decided to achieve such adjustment primarily through a program of domestic cost reduction; substantial progress has been achieved on defining the main elements of such a program, details of which are provided in Part I of the attached President's Memorandum:

(i) regulatory reform to liberalize the economy and allow for a reduction in domestic prices and wages, by simplifying or dismantling the complex web of controls and regulations that hamper the Ivorian productive sectors;

(ii) rehabilitation and/or privatization of public enterprises in an effort to move away from inefficient parastatals providing essential services to the private sector, and reduce the cost structure of the Ivorian economy;

(iii) tax and tariff reform to simplify fiscal mechanisms, in an effort to improve collection while reducing statutory rates, which will remove distortions and again lead to reductions in the cost structure of the economy; and

(iv) reductions in Government spending. No medium-term program will be viable if it is accompanied by large fiscal deficits. Therefore, a further cut in Government spending will be made, targeted at recurrent costs as investment spending is already at a bare minimum. In this context, the anticipated reduction in the civil service wage bill will induce an overall fall of wages in the economy, leading to enhanced competitiveness for Côte d'Ivoire.

10. The precise details of this program are being worked out by the Government at the present time, with the assistance of Bank staff. Ongoing work involves: a Bank/UNDP financed study of the competitiveness of the Ivorian economy, to be completed by end-December; a public expenditure review, to analyze the investment and recurrent budgets as well as the situation of key public enterprises, for which a Bank mission is currently in the field; and a resource mobilization report presenting recommendations concerning the financial sector and the tax system, elaborated by Bank staff in 1988. Further work on the financial sector was carried out by a recent Bank sector mission, and will lead to added recommendations to ensure that financial institutions are in a position to actively support the adjustment program.

11. Implementation of specific measures of the adjustment program is to commence as soon as possible, in some cases during 1990, in others over a longer period. It has been agreed that the Government will continue to work closely with Bank and Fund staff on refining and implementing these measures.

12. We feel it is necessary to proceed at once with the ESAL, for three main reasons: first, the operation will make a significant contribution to the Government's ongoing adjustment effort; second, disbursements under ESAL as well as the other Bank financed SECALs will improve public sector cashflow and are an integral part of the financing plan underlying the IMF standby program; and third, effectiveness of ESAL will trigger cofinancing from other donors, EIB and the Caisse Centrale in particular. These resources will be essential to carry out the short-term stabilization in its entirety.

Attachment.

AF1
November 21, 1989

Distribution

Operations Committee members:

Moeen A. Qureshi, SVP Operations (Chairman)
S. Husain (LACVP);
E. Jaycox (AFRVP);
A. Karaosmanoglu (ASIVP);
E. Lari (EMNVP);
V. Rajagopalan, S. Fischer (PPR);
I. Shihata (LEGVP);
K. Kashiwaya (CFSVP);
D.J. Wood (FPRVP);
H. Vergin (OPNSV)

Other Participants:

D. Lee (COD);
V. Dubey (EAS);
A. Shakow (SPR);
J. Holsen (CEC);
D.C. Rao (FRS);
D. Bock (CFS);
S. Burmester, T. Thahane (SECGE);
D. Goldberg (LEGOP);
N. Okonjo-Iweala (OPNSV).

For Information:

W. Thalwitz (PPRSV);
J. Parmer (IFC-CIO);
J. Linn (IEC);
B. Kavalsky (FRM);
G. Pfeffermann (IFC-CEI);
R. Liebenthal (SPRPA);
F. Kilby (FRS);
C.L. Robless (OPNSV);
M. Haug, A. Khanna (EXC);
R. Agarwala (AFRCE).

Messrs. O'Brien, Denning, Ms. Guerard;
Mr. E. Grilli;
OPNSV staff;
AF1 Management Team, AF1 Cote d'Ivoire Team, Messrs. Chaparro, Ghanem;
Messrs. Spota, Christoffersen, Peberdy, Guillou.

November 27, 1989

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THE WORLD BANK

Operations Committee

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Minutes of the Operations Committee to Consider
SENEGAL - Transport Sector Adjustment/Investment Credit; Initiating Memorandum

Held on Monday, November 27, 1989, at 11:00 a. m. in Room E1243

A. Present

Committee		Others	
Messrs.	A. Karaosmanoglu, Acting Chairman	Messrs./Mmes	M. J. Gillette, AF5DR
	V. Rajagopalan, PREVP		V. Dubey, EAS
	E. V. K. Jaycox, AFRVP		P. Watson, AF5IN
	B. G. Kavalsky, FRM		F. Agueh, AF5PH
	H. N. Scott, LEG		F. L. Laporte, AF5DR
	E. F. Lari, EMN		F. Peloschek, LEGAF
	N. D. Roger, LAC		G. Sicat, EAS
	H. Vergin, OPNSV		A. Harth, COD
			M. A. Fardi, SPRPA
			P. J. Dufour, FRM
			Y. Jones, CFS
			G. Swamy, AFRCE
			H. P. Crevier, SEC

B. Issues

1. The Committee discussed mainly the following issues: the justification of the hybrid design and the disbursement method of the quick disbursing component; the performance of Bank programs in the transport sector in Senegal; and the environmental dimension of the project. The discussion thus covered essentially the agenda prepared by EAS.

Hybrid Design

2. Justification. A member stated that the transport sector investment project was well-prepared. At the outset, however, the member pointed out that the operation should not go ahead of SAL IV, and that having an acceptable macroeconomic framework in place should be an essential condition for considering a hybrid operation. Other members also stressed that the hybrid credit design required a stronger justification. Some questioned whether the transport sector investment project was the appropriate vehicle for providing part of the quick disbursing money required to meet the overall balance of payments needs

of the adjustment program. It could be more appropriately be provided by increasing the size of SAL IV. The Chairman said that if the main issue was to find a means of funding road maintenance, this could better be accomplished by the use of a revolving account, which would be replenished on a yearly basis, as had been done in similar transport sector operations. He further noted that if the justification were not strong enough for the application of quick disbursing money, it could lead to a precedent for funding investment operations in other Regions of the Bank with a quick disbursing component. Members felt that by using the hybrid design, the implementation of the transport sector project, which was desirable in its own right, would be made dependent on macroeconomic performance conditionality. Thus, if the macroeconomic program were to go offtrack, the project would be adversely affected. In fact, any shortfalls in macroeconomic performance could also lead to a reduction of the road fund allocations under the project. This would not happen necessarily under a simple sector investment credit. Another issue was the specific macroeconomic linkage to be established in the case of the transport sector project. Would this be made through an annual public expenditure review or through the conditionality of SAL IV? Another member wondered whether the quick disbursing element was designed largely as a reward for past or existing conditionalities in adjustment operations. Finally, members wanted to know the overall volume of quick disbursing funding that was planned during the fiscal year and whether that volume, including that planned for the proposed transport credit, was justified by the level of balance of payments financing.

3. In replying to these issues, the Region first touched on the adjustment program being sought under SAL IV, which was about to be negotiated. The ambitious program for reducing the wage bill and the wage rate and the downsizing of the civil service would, if successful, generate significant savings for the economy. These savings would partly go to high priority development projects, including those in the transport sector. As to why the transport sector credit needed a quick disbursing component, the Region stated that, apart from the usual justification that both investment and policy changes were required to bring about a supply response, one of the purposes of the operation was to bring the level of commitment for transport maintenance, not only from the already committed transport ministry, but particularly from the Finance and Planning Ministries. This was essential because sectoral issues generally suffered often from insufficient attention from those parties in government. Extending the country dialogue with these ministries on sector issues would assure that appropriate linkage is made to the macroeconomic ministries. This, however, required that some funding, which was not tied to the transport sector, would be made available to the Government. Thus, although the Region recognized that there were alternative means of funding Government budgetary needs (for instance, raising the funding of SAL IV), the Region also expected that SAL IV was expected to be in place and therefore any link to macroeconomic conditionality would be ensured. Since it would be unlikely for the borrower to fulfill its commitments under the Credit in the absence of sound macroeconomic performance, the Region welcomed the linkage with macroeconomic performance. The Region further stated that the hybrid credit design filled a particular lacuna in the operational toolbox for the Africa Region by permitting the diversification of quick disbursing vehicles for SPA, by focussing attention more clearly on

sectoral issues and by relieving the burden of having sector conditionalities in the SAL which might endanger the release of a SAL tranche due to noncompliance with a sectoral condition. The Region further pointed out that the use of the hybrid credit design had been already justified in Senegal's context during the discussion of the CSP recently. Moreover, the contents of this strategy had been prenegotiated with the Senegalese authorities as representing a response to their need for adequate macroeconomic funding. With respect to the overall funding of adjustment in Senegal, the Region indicated that the quick disbursing funds proposed to be supplied for the current fiscal year would be about US $150 million, which would constitute the initial tranches from FSECAL, SAL IV and the proposed transport credit.

4. Method of Disbursement of Quick Disbursing Component. Some Committee members felt that in the case of a transport sector hybrid credit, the adjustment portion should be disbursed against a positive list of imports. If the quick disbursing component were added to the funding of SAL IV, this issue would not arise since that would simplify the disbursement against a negative list, which was desired by the Region. The Region stated that the sectoral import funding gap was small, since sectoral imports had already been funded by other donors.

Other Issue: Complexity. Some Committee members felt that the project was already a complex one covering all the transportation modes and addressing investments, institutions and market issues relating to efficiency and public enterprise behavior. To all this was being added the additional complexity resulting from its hybrid design. Since the efforts to increase efficiency in transportation had faced difficulties in the past, supervision of the project was crucial for successful implementation. It was agreed in this context that adequate resources would be provided for supervision.

Transport Sector Operations of the Bank/IDA in Senegal

5. The Committee asked the Region to review the nature of the Bank's involvement in the transport sector in Senegal. The Region provided a brief review of the various transportation sector loans to the country. The Region expressed the view that there was a poor record in bringing about policy reforms in any of the modes of transport. However, the Region stated that the proposed hybrid operation would provide an improved vehicle for bringing about adequate adjustment in the sector.

Environment

6. In response to the Chairman's query on the environmental dimension referred to in the Initiating Memorandum, the Region explained that the Bank had expressed concern that a road project was being proposed to cut through a national park, which would then pose some environmental concerns. The Region explained that this would be looked into carefully, especially in the context of alternative plans, such as the control of speed or a detour of the project. The Region said that this issue was sufficiently important to warrant requiring it as a condition for Board presentation.

Decision

7. The Chairman summarized the meeting by saying that the Committee was not yet fully convinced by the hybrid credit vehicle in this case, but that if the macroeconomic framework were satisfactory, the hybrid design should be considered. He further stated that the Region be allowed to appraise the project and required that the appraisal report should contain a statement of what had been accomplished in the transport sector in previous operations, what specific efforts were needed to make a difference in the sector, and why a hybrid credit would be needed.

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December 4, 1989

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HE W[LD BANK/INTERNATIONAL FINANCE CORPORATION

)FFICE MEMORANDUM

ATE : November 21, 1989

O : Operations Committee

V. Dubey

ROM : Vinod Dubey, Director, EAS

XT. : 78051

UBJECT: Senegal -- Transport Sector Adjustment/Investment Credit
Initiating Memorandum.

1. The Operations Committee will meet on Monday, Nov 27, 1989, at 11:00 a.m., in Room E-1243 to consider the Senegal Initiating Memorandum for a Transport Sector Adjustment/ Investment Credit. The following represents a proposed agenda. Please note the change in the meeting date and time.

Background and Macroeconomic issues

2. Recently, the Operations Committee met to discuss operational work on Senegal: on August 9, 1989, the CSP and the Initiating Memorandum for SAL IV; on October 20, 1989, the Initiating Memorandum for the Financial SECAL; and more recently (on a no-objection basis) the Fourth Year PFP for FY1989-90-1991-92. One of the problems of Senegal's economy is that, despite several SALs, the supply response has been relatively low. Some of the policy issues related to this low supply response are sought to be addressed by these recent operations.

3. The Committee may want to ask Region to give an update of the developments with respect to SAL IV, the FSECAL, and the macroeconomic program in the context of the Fourth-Year PFP. To what extent do these recent developments indicate that there is determination on the part of the Government to undertake structural adjustment reforms? And how is the proposed transport sector credit linked with the sequence of reforms being undertaken in the economy?

The Transport Sector

4. The Region states that previous operations in the transport sector have sensitized the Government to the following problems in the transport sector: lack of funding of transport maintenance; poor investment planning; costly implementation; and inefficient institutional performance. The Committee may wish to ask the Region to elaborate on how the proposed operation would address these deficiencies in the transport sector, and in particular address the following issues:

- Shift of allocation of resources from new investment to maintenance of roads: the Road Fund. The Region should explain why in the context of Senegal the maintenance of the road system should take priority over new road investments. How will the government address the issue of new transport investment? The Region should further elaborate on the funding mechanism in the budget which is through a special Road Fund. The Region should explain the extent to which this mechanism, while achieving its role in isolating funds for road maintenance reduces budgetary flexibility for the Government. Is this institutional procedure considered a temporary or permanent innovation.

♦ Allocation of credit: why mainly for road transport? The proposed transport credit is largely designed to finance road transport maintenance, absorbing 80% of the proceeds. Is this heavy tilt towards the road transport subsector justified in the context of the transport needs and priorities in Senegal? Can the Region explain whether the allocation for railroad, airport, seaport subsectors are not being neglected? Are there related projects designed to address these other sectors or are the institutional and other policy adjustments (re financial autonomy) sufficient to reform these sectors?

5. With respect to the allocation of funding for transport maintenance, will the Region explain what safeguards are in place to assure that priority is given in maintenance to highly productive roads? How would the funding allocation distinguish between rural and urban transport networks?

♦ Improving operational efficiency and financial autonomy: tariff rate adjustments. Various segments of transport services are provided by public enterprises. This has led to the growth of transport subsidies indirectly through the deficits of these enterprises and has caused fiscal deficits to continue.

6. The proposed operation suggests specific measures to restore financial autonomy through increases in the tariff rates charged by these enterprises for their services and through the use of improved contrat-plans in respective enterprises. On the other hand, the experience in Senegal has not been satisfactory on this account because the agreed tariff rates were not implemented adequately. Are there any reasons why expectations should therefore be any different about the ability of the Government to implement the tariff rates and the principles underlying them as proposed in this operation? Would it be more appropriate to institute more upfront policy actions by the Government to assure that the required measures are undertaken?

♦ Improving operational efficiency: any role for the private sector? The Region notes that the private sector has played a very limited role in the transport sector of Senegal. What options have been explored by the Region to assure a possible larger role for the private sector in the proposed operation? What stumbling blocks are present which prevent such options from being considered? Are there any long-term plans addressing these issues?

Justification for Hybrid Credit Design

7. The Region proposes a project amounting to US$410 million, composed of a quick-disbursing component (over a 36 month period) of US$20 million to provide balance of payments and budgetary support and a US$390 million for an investment component. IDA's share of this credit is likely to

be about US$36.4 million (See Table 1, p. 14), of which about 43% is to finance the quick disbursing component.

8. The Committee may want to ask the Region why a hybrid credit is being sought considering that other quick disbursing adjustment credits (SAL IV, FSECAL) are in the pipeline. Would an investment credit not be the more appropriate mechanism for this type of operation considering that the hybrid operation would subject the investment operation to macroeconomic conditionality?

9. Tranching and disbursement. The quick disbursing component of the credit is to be released in three chances of US$6.5 million against a negative list of general imports. Can the Region explain the possibility of disbursement against a positive list, given that imports related to the transport sector are likely to be easily procured?

Cofinancing and burden sharing

10. The proposed credit involves an extensiive amount of cofinancing with several creditors and donors. The Region may want to explain the extent to which the financing gap is filled and the nature of the contribution expected from IDA in case the gap is not filled.

Operations Committee

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Lari, Fischer/Rajagopalan, Shihata, Kashiwaya, Wood, Vergin.

cc: Messrs. Lee, COD; Shakow, SPR; Holsen, (CEC); Rao, FRS; Bock, CFS; Burmester/Thahane, SECGE; Goldberg, LEGOP; Ms. Okonjo-Iweala, OPNSV; Sicat, EAS; Gillette, Hinkle, Laporte, Thalwitz, PPRSV; Parmar, IFC-CIO; Linn, IEC; Kavalsky, FRM; Pfeffermann, IFC-CEI; Liebenthal, SPRPA; Kilby, FRS; Robless, OPNSV; Ms. Haug, EXC; Khanna, EXC; Agarwala, AFRCE.

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November 20, 1989

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THE WORLD BANK

Operations Committee

CONFIDENTIAL

Minutes of the Operations Committee to
consider PHILIPPINES DEBT MANAGEMENT Loan
held on November 20, 1989 at noon in Room E-1243

A. Present

Committee		Others	
Messrs.	M.A. Qureshi (Chairman)	Ms.	D. Gressani (AS2CO)
	S. Husain (LACVP)	Messrs.	D. Bock (CFS)
	E. Jaycox (AFRVP)		F. Chaudhri (EAS)
	A. Karaosmanoglu (ASIVP)		E. Grilli (EAS)
	S. Fischer (DECVP)		N. Hicks (SPR)
	I. Shihata (LEGVP)		K. Ikram (AS2CO)
	J. Wood (FPRVP)		K. Jay (SPRPA)
	K. Kashiwaya (CFSVP)		D. Leipziger (AS2DR)
	E. Stoutjesdijk (EM3DR)		G. Kaji (AS2DR)
			G. Oliveros (FRS)
			D.C. Rao (FRS)
			J. Shilling (CFS)
			K. Siraj (CODOP)
			A. Toft (CFS)
			O. Yenal (ASIVP)
			U. Baumgartner (IMF)

B. The Operations Committee met on November 20, 1989 to consider the draft Report and Recommendations of the President and policy letter in respect of the above loan in the amount of US$200 million. The issues raised fell in three broad clusters: a discussion of the deal, including the choices of the commercial banks between new money and buybacks and their implications for the financing package; the appropriateness and adequacy of conditionality in the proposed operation, including conditions for tranche releases; and the benefits of the proposed operation.

C. The Discussion

At the outset the Chairman asked the Region to give an update on the commercial banks' offers, associated to the debt reduction operation, and to comment on their possible implications.

In response the Region informed the Committee that so far the commercial banks had offered $1.8 billion for debt reduction operations, which is in excess of the $1.3 billion debt that can now be bought back by the government of the Philippines, and just over $600

million of new money, which is below the original firm estimate of $850 million. Since the commitment so far for the new money was considerably below the original expectations, the Chairman asked whether the package still looked viable. One Committee member felt the commercial banks' constrained interest in the new money reflected their concern about insufficient Government liberalization efforts and the current limit (40%) on the equity participation by foreign investors in the Philippines. Another Committee member wondered whether the IMF program was sufficiently long-term to ensure the viability of the debt reduction operation. In general, the Region's assessment indicated that even if the commitments for the new money were falling somewhat short of the original estimates, the proposed operation was still viable. It emphasized, however, that not all the responses were in and that there was still enough time to make further progress on new money commitments.

One Committee member cautioned that the Bank should not give the impression that the debt reduction operations could be used to enforce commercial banks' conditionality. He also mentioned that the Chairman's summing up of the Board Discussion on the Operational Guidelines justified stand alone operations if (a) the Bank's lending strategy was concentrating on investment operations and (b) the Bank was satisfied with the macroeconomic medium term program. He felt that even though the proposed operation was marginal, it was not too marginal to cause him to oppose it on materiality grounds. He wondered, however, what mechanism would ensure the fulfillment of the macroeconomic conditionality and the release of the second tranche under the proposed operation. Finally, he raised the question as to whether the IMF framework was of adequate duration and stated that he assumed that disbursement of Bank loan would be made directly to the commercial banks.

Another Committee member asked whether it would be desirable for the Bank to encourage the commercial banks to get out of the buying back activities and do more on the new money side. At this stage the Chairman also asked "to what extent the indicated response on the new money would vitiate the underlying Bank strategy to resolve the debt problem". Questions were also raised on the country's debt profile after 1992 and whether continued reschedulings were an accepted part of the medium-term financing strategy.

The Region referred to the revised Table 5 that showed the financing gap after the commercial banks' rescheduling was rolled over, but before another Paris Club rescheduling was factored in. The gap was manageable and thus, even if new money fell somewhat short of the target, the strategy for dealing with the debt problem would not be vitiated. The Region also referred to the Philippines' statement of medium-term policies which, in the Region's judgement, presented a very comprehensive framework within which the country intended to operate.

Following a question as to the nature of the second stage operation envisaged in the proposal, the Region replied that it would be of limited scope and largely of a 'transactional' type operation - i.e. involving the targeting of individual banks and menus to suit their specific preferences.

On the issue of conditionality, the Chairman raised three questions: (i) how does it reflect the earlier Board discussion; (ii) how is it linked to the IMF position; and (iii) whether it envisages upfront actions in order to establish a satisfactory program next year. Another Committee member enquired whether it was appropriate for the proposed operation to cover a wide spectrum of issues.

The Region recalled the Board debate on the use of the stand alone operations versus the existing loans for debt reduction activities in the Philippines. It recognized that the set of conditions now being envisaged was wide-ranging and also targeted towards administrative type actions, but emphasized the country's strong need for 'nitty gritty' measures in order to avoid "frustration of policy objectives because of administrative hurdles". With respect to the IMF position, the Region stated that while the fiscal deficit was worrisome because of the recent minimum wage increase and delay in raising oil prices, the overall revenue targets had been met. The Fund representative informed the Committee that the first review under the Extended Fund Arrangement had been completed. There was some slippage in the first half, but some measures have already been introduced to correct the situation and others are expected shortly on the revenue side. The Fund was concerned about the possible shortfall in the new money and the resource constraints of buying back debt in excess of US$1.3 billion. The Committee was informed that following a satisfactory staff review, the relevant documents would be sent to the Board at end November for a Board meeting on December 18, 1989. The Fund staff would recommend that management bring forward into 1989 the two set-asides scheduled for 1990.

The Chairman stated that it was important to set out clearly in the report what macroeconomic actions had been taken and what further measures were intended to be taken.

One Committee member felt that it was not clear under what circumstances the Bank would not release the second tranche. The Region replied that the second tranche would not be released if the country had failed to adhere to Fund conditionality which the Bank had incorporated in its own loan agreement. While the Bank would rely on the Fund to monitor compliance, the Bank would make its own judgement on whether shortfalls were significant. With respect to the non-macro conditions, the Region reiterated how important they were for the implementation process and for building up the pipeline of projects. The Chairman observed that the Region should tie down the second tranche to only those conditions that were desirable and necessary.

One Committee member observed that the program did not focus on the government's strategy for non-traditional exports; (b) the Philippines had not specified the measures it intends to take to improve the investment climate in the country and (c) there was no discussion of the capital flight problem and the adequacy of the exchange rate policy.

The meeting was informed by the Fund representative that there was some evidence of capital flight reversal and that issue of capital flight would be dealt with quite extensively in the forthcoming staff review. He also indicated that there had been a very strong upsurge in investment in 1989. He also felt that the exchange rate was currently not grossly out of line, but stated that the Fund would continue to monitor it very closely.

As to the benefits of the operation, part of which were reflected in a substantial increment in GDP growth, the Chairman felt they seemed over-stated in the report, insofar as they were made to depend on a set of circumstances (both political and economic) whose likelihood was difficult to judge. The Region stated that the implication of the operation not maturing would be quite significant and serious both for the domestic political and economic prospects. The Region agreed, however, that the modelling exercise was very sensitive to the use of different assumptions and that they would attempt to reformulate the relevant sections of the report discussing the importance of the debt operation for the medium prospects of the Philippines without an excessive reliance on simulations.

The Chairman suggested it might be better to start-off e.g. para 34 by stressing the positive things that this operation would accomplish. Another Committee member also felt that it would be a dangerous line of argument if the paper mainly stated what terrible things would happen if the operation did not go ahead. He felt that certain benefits, e.g. those related to improvements in investor confidence, should be given more emphasis, without attempting to quantify the precise impact on investment levels and growth prospects. The Chairman endorsed this idea.

The specific question of 'materiality' also came under discussion. The Committee was informed that the legal bases for debt reducing operations were the positive and significant effect on the investment levels and growth prospects of the economy. Since such effects were also matters of judgement, the Chairman asked whether some clearer indicators like the financial and economic rates of return were not more useful concepts. The General Counsel explained that before the rate of return is to be established the operation has to fall within the legitimate scope of Bank intervention. The Bank is not authorized under its Articles to make just any loan for a high rate of return. If not for a specific project, the loan has to facilitate investment for productive purposes. Even then, this is an exception from the rule of specific project financing.

In the discussion that followed the relative merits of the financial/economic rates of return and full-blown, economy-wide scenarios were debated. Finally, it was stressed that what was important was the material effect on investment in the economy, and its contribution to the growth process. The sense of the meeting was that the regions have the flexibility of using various analytical devices but the essential need is to make a plausible and convincing case that the proposed operation, perhaps as part of the overall financing strategy, is likely to have a substantial impact on the level of investment; beyond this the rate of return should be used as a further criterion for whether the operation is economically justifiable.

The Region was advised to revise the draft Président's report in light of the OC meeting discussions and authorized to initiate negotiations of the loan with the Philippine Government.

November 27, 1989
FMChaudhri:gs

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 16, 1989

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXTENSION: 78061

SUBJECT: PHILIPPINES: Debt Management Loan - Agenda

Macro —
Housekeeping rule
Real conditionality
Substantial drafting was asked by the Bd.
Let the Macro affirm actions

There will be a meeting of the Operations Committee on Monday, November 20, 1989 at 12 noon in Room E-1244 to discuss the Philippines Debt Management Loan.

This proposed loan is scheduled to be negotiated on November 24 and presented to the Board around December 19, 1989. This timetable is necessary because the Philippines must have the funding for its buyback in place by January 3, 1990 in order for the buyback to take place on schedule. By the terms of the agreement, the buyback must occur before the new money becomes available. This also explains the relatively short period given for review, which we regret. The Committee may wish to consider the following points in its discussion.

Responses from Comm Bks. Is it a good deal.

The Philippines has enjoyed quite satisfactory recovery and growth with conventional rescheduling. The commercial debt is a relatively small share of the total debt (about 30%), and the bilateral donors have been relatively generous with their aid recently. The region may wish to explain: why debt reduction is critical at this juncture, whether it will be sufficient to meet the financing requirement over the period covered, and what is its longer term impact on debt and debt service burden. It may also clarify whether and why further debt reduction measures will be required after the two-year period covered by the new money agreement. Also in what ways the proposed operations makes a material contribution to the country's development prospects.

The Philippine debt reduction proposal does not at this time include any exchange instruments as in Mexico, nor does it cover all the outstanding commercial debt (except for a modest reduction in the spread over LIBOR). The Committee may want to ask the region why this approach was preferred and whether it represents an effective use of Bank resources in terms of the economic impact of the debt reduction program. Also, is not the period over which the benefits are to be derived too short and would the country's longer term access to commercial credit really improve?

Design of the Standalone Operation of Conditionality

The region has proposed a stand-alone operation to support debt reduction with the funds set aside from the country's three-year lending program. Is the Committee satisfied that this is consistent with the guidelines for debt reduction operations? The region may want to clarify whether the macro economic framework is sufficiently strong to justify such an operation in view of some performance shortfalls in the IMF program (since rectified) and the Bank's current adjustment operations and to elaborate on recent actions to assure that the economy maintains a satisfactory framework. Is the IMF's program sufficiently long-term in its conditions to satisfy the Bank's medium term objectives?

Besides a reaffirmation of conditions in existing agreement the proposed loan contains a number of specific conditions for effectiveness and tranche release. The Committee may wish to consider whether this conditionality, which is mostly related to administrative procedures, is sufficient and commensurate with the Bank's financial involvement.

Conditionality

The preliminary responses from the commercial banks should be available. The region may wish to report on them and indicate to what extent they conform with expectations, or if not, what the impact of any significant deviation would be on the financing plan or the country's growth prospects.

The region has presented a separate memo discussing the impact of the Philippine lending program on the Bank's exposure guidelines. As a set aside, the operation would not increase our exposure beyond what had been planned, except for the short term effect of accelerating disbursements somewhat because of the rapid disbursing nature of the loan. However, it will involve the Bank more deeply in the debt reduction operation rather than supporting critical imports, and it will reduce the amount of commercial debt subject to future restructuring, if needed. Is the Committee satisfied that the risks involved in the proposed operation are acceptable, both in terms of the relative increase in the share of the Bank in total debt (as some commercial bank tender their debt for cash) and of the reduced cushion of commercial debt that will remain should there be further debt problems in the future.

Exposure

Robustness Complication

The Bank has no prior experience in lending directly to support debt buybacks. Is the Committee satisfied with the disbursement and monitoring arrangements?

Operations Committee

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Lari, Rajagopalan/ Fischer, Shihata, Kashiwaya, Wood, Vergin

cc: Messrs. Lee, COD; Shakow, SPR; Holsen, CEC; Rao, FRS; Bock, CFS; Burmester/Thahane, SECGE; Goldberg, LEGOP; Ms. Okonjo-Iweala, OPNSV; Chaudhri, EAS; Thalwitz, PPRSV; Parmar, IFC-CIO; Linn, IEC; Kavalsky, FRM; Pfeffermann, IFC-CEI; Liebenthal, SPRPA; Kilby, FRS; Robless, OPNSV; Ms. Haug, EXC; Khanna, EXC; Kaji, AS2DR; Ikram, AS2CO.

JShilling/FMChaudhri:gs

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

89111509 1.

Date: November 15, 1989

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

From: Attila Karaosmanoglu, Vice President, Asia AK.

Extension: 72283

Subject: Philippines: Proposed Debt Management Loan in the Amount of $200 Million

1. Attached is a draft Report and Recommendation of the President and Policy Letter in respect of the above loan.

2. This operation has been put together within very tight time constraints following the extended discussion at the Board on October 26 (when the outlines of this operation and our approach were discussed at length) to accommodate the Philippine need to consummate the debt buy back on January 3 in accordance with its term sheet. We propose to have the proposed operation considered by the Board no later than December 19. We have therefore requested, subject to the concurrence of the Operations Committee Members, that this matter be placed on the Operations Committee Agenda urgently. I would also add that given the pace at which developments have taken place, we could not go through the normal process of an initiating memorandum clearance by the Operations Committee. While there are still some refinements required to the draft Report and Recommendation of the President for final distribution to the Board, the basic elements describing the operation and justifying it are adequately set forth in the attached document.

3. We would also like to provide in this memorandum an assessment of country risk and implications for Bank exposure and risk management which cannot be dealt with as fully in a draft Board document.

4. As we stated in the Country Risk Assessment note of May this year, which was developed with the Finance complex, our overall assessment continues to be that, while the level of external debt in the Philippines remains high, the creditworthiness position of the country continues to improve, reducing the risk for continued Bank lending, including this proposed operation. The down side risks, both external and internal, remain as described in that note. The political situation while stable, is still characterized by conflicts between the Legislative and the Executive branches of Government and this may get sharper both with the forthcoming elections in 1991 and the start of negotiations on US Bases. This could compromise the reform process and in a worst case scenario, lead to backsliding of past reforms. While the Government has stood steadfast on actions implemented and has continued to push through the reforms, the Government's willingness and ability to push additional new legislative measures is clearly constrained. However, the number of reform measures now required for deepening the process lie much more within the control of the Executive branch, and while debate in the Legislature may be unavoidable, it does not preclude freedom of action as stringently as would be the case if major corrections requiring legislative approval were still on the Government agenda.

5. While there was concern that on the fiscal side that the tax targets contained in the EFF would not be met, experience to date, as recorded in the Fund's report, indicates that tax targets agreed with the IMF were in fact fully met. On the expenditure side however, the action on minimum wages and slowness in adjustment of oil prices did lead to a larger deficit, on account of expenditures being higher than projected. However, corrective action has been agreed and the Fund feels comfortable enough to proceed to recommend to its Board the advancing of the 1990 tranches for financing the debt buy-back. The long run structural issues, particularly the high level of poverty and unemployment in both urban and rural areas, continue to be major problems compounded by high population growth rates, and the implications that this has for environmental degradation. These are specifically the areas that we are now addressing with the Government, and is the major pending area where the Government's resolve will be tested.

6. The risk from the external environment, and particularly as it relates to oil prices increases, movement in interest rates and protection against manufactured exports, have been addressed. For example, the oil price if 10 percent higher, would add about $130 million to the current account deficit; an increase in interest rates of one percentage point would add another $190 million to the annual interest bill; a drop in the export growth rates of one percentage point would increase the current account deficit by about 10 percent above the present forecast. The Philippines has a limited cushion to meet some of these down side risks by virtue of the $400 million contingency financing arrangement incorporated in the EFF Program.

7. In respect of Bank exposure, our projections, including the proposed loan, would indicate that the absolute exposure guideline of the share of total Philippine debt in the Bank's portfolio, is never violated. The guideline concerning capacity to service debt obligations requiring that the ratio of IBRD debt service to export revenues not exceed 4.5 percent for Category IIIB countries, would be marginally violated in 1990 when it reaches 4.7 percent. However, it should be noted that this indicator was breached in 1988 and 1989. What is important to note, however, is that the ratio declines after 1990, reflecting the country's increasing ability to service debt.

8. The share of IBRD and preferred creditors (including IMF) in public and publicly guaranteed debt service, does not exceed Bank guidelines. IBRD's share remains below 20 percent and the share of preferred creditors below 35 percent. Finally, we have tested the Philippines against the indicators of financial robustness which have been developed in the context of the new guidelines. The share of "inflexible" debt service in total debt service remains below 50 percent during the projection period and declines throughout the period. The significant indicator of robustness, the ratio of net inflow of flexible debt to interest payments on it, is large and increasing, indicating that the transfer from bilaterals and commercial banks exceeds interest payments due to them.

9. Despite the high debt problem, the Philippines has diligently serviced all its debt, and in the case of the Bank, has rarely had arrears of more than 15 days. The relationship with the Bank remains sound. Significant progress has been achieved in development of our own program and our strong coordinational role of all official assistance has been significantly enhanced under the Multilateral Aid Initiative. Thus, despite Philippines' high level

of debt and debt service and the Bank's high exposure, the level of risk is manageable when placed in the context of the improved economic performance; the favorable overall prospects for external financing, significantly improved by the MAI and the commercial bank package; the cooperative relationship with the Bank; and the record of prompt debt service to the Bank and other creditors.

cc: Operations Committee Members

GSKaji/jh

PQU15008 2

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 15, 1989

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS V Dubey

EXTENSION: 78051

SUBJECT: PHILIPPINES: Debt Management Loan

An Operations Committee meeting will be held on Monday, November 20, 1989 at noon in Room E-1243 to discuss the green cover package for the above-mentioned operation. The agenda will follow shortly.

Operations Committee:

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Lari
Rajagopalan/Fischer, Shihata, Kashiwaya, Wood, Vergin

cc: Messrs. Lee, Shakow, Holsen, Rao, Bock, Burmester/Thahane
Goldberg, Ms. Okonjo-Iweala, Thalwitz, Parmar, Linn,
Kavalsky, Pfeffermann, Liebenthal, Kilby, Robless,
Ms. Haug, Khanna, Kaji, Ikram

FMChaudhri:gs

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 15, 1989

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

V Dubey

EXTENSION: 78051

SUBJECT: EGYPT: Country Strategy Paper
Proposed Agenda

1. The Operations Committee will meet on Monday November 20, 1989 at 9 30 ~~2.30 p.m.~~ in Room E-1243 to consider the Country Strategy Paper for Egypt. The Committee may wish to take up the following issues for discussion.

Background

2. The CSP contains a vivid description of Egypt's economic problems. This includes a large and rapidly growing population, a deteriorated infrastructure, unemployment, diminishing oil exports, an inefficient industrial sector and unmanageable external debt burden, a restrictive trade regime, distorted pricing and a profusion of regulations administered by a pervasive as well as inefficient public administration. Included in this scenario also are untenable fiscal deficits, and a wide external gap, a sizable part of which remains unfinanced. This state of affairs is unlikely to be able to continue, and reforms which should have been initiated earlier are now much more difficult in terms of political feasibility. This picture presents the Bank with a most difficult agenda for action, and the Region has been battling with a strategy for several months, and over a number of working level meetings in which PPR and Finance have also participated.

3. The last strategy paper for Egypt (a CPP) was approved in November 1985. Meanwhile annual lending has been fairly low and fluctuating with no adjustment lending attempted, even when the Fund had a Stand-by in 1987 which soon afterwards aborted. Lending was $70 million (one project) in FY86; nil in both FY87 and FY88; $241 million in FY89 and is projected at $82.5 million in FY90. Only a three-year program, covering the period FY90-92, is being proposed, to be reassessed in two years' time. Three scenarios are elaborated: (a) a base case implying a continuation of the present momentum for mild reform, with annual lending proposed at $250 million all in investment loans; (b) a high, but less likely, case with a lending level of $800-1,000 million per annum including adjustment lending; and (c) a downside "risk" case where the present pace for reform slows or stops and the recommended level of lending is $125 million a year. The main rationale for lending in the base case, which the CSP recognizes as unsustainable in the long run, is that it would sustain sectoral initiatives underway. Para 55

Minimum necessary to keep on dialogue

The SAL Mission

4. A SAL preparatory mission has been in Egypt in October/November to explore the feasibility of a structural adjustment program that would elevate Bank lending into the higher case. The IMF which has mounted a

number of missions to initiate a stabilization program, seems to have vacated the driving seat to the Bank, pressing the need for structural reforms to precede a stabilization program.

- In light of the mission's findings the Region might give an updated assessment of the macroeconomic situation and Egypt's commitment, if any, for reform.

- Does Egypt see eye to eye with the Fund on the needed changes in interest and exchange rates and the budget deficit? And is a Fund-supported stabilization program in the offing?

- In view of the fact that the financing a gap is too large for any medium-term adjustment program to succeed, and might be a factor behind the IMF reluctance to proceed with a stabilization program, how realistic is it that a meaningful structural adjustment program leading to the high case can be formulated and implemented?

Debt, Debt Relief and Creditworthiness

5. Total external debt is estimated to be in the neighborhood of $50 billion, exceeding 180% of GDP [if calculated at "the new commercial bank rate of exchange" (para. 7)]. For 1990 the Key Indicators (Annex A p.1) using an overvalued exchange rate, puts the DOD/GDP ratio at 144.5%; [debt service $6.3 billion, Annex A, p. 5]; debt service to GDP at 18.9% and interest payments to GDP at 8.7%. With optimistic assumptions (Table 4, para. 37) financing requirements (about half for the current account deficit and half for amortization) are set at $6.8 billion a year in 1990-92, with an annual financing gap (including arrears) of $3.7 billion. This would be sought in a combination of "exceptional" debt relief, and new commitments.

Financing Gap. Is this realistic. What happens if not fulfilled

- Considering that the bulk of Egypt's debt is owed to official creditors, is an initiative needed and likely to succeed to induce some debt reduction outside the Paris Club context?

- Does the debt picture change materially in light of the analysis of new debt data by PPR's IECDI Division, expected to "become available in October 1989" (para. 43)?

- ? Since debt service is crippling, what is the sense of elaborating Bank exposure in terms of Egypt's total debt service obligations and reaching ostensibly acceptable levels? The Region might elaborate on Egypt's creditworthiness under all three scenarios.

What was Per Capita Income? compared to 5 years ago

The Level and Efficiency of Investment

6. A striking feature of Egypt's economy is its slow growth (slower than population), beginning in the mid-eighties and projected to continue until 1997, with consumption per capita already seriously eroded (real wages in FY87 were 66.3% of their level five years earlier, Annex Table A1) and declining by about 1% a year on average to the end of the projection

period. Gross investment is currently about 21% of GDP projected to decline to 18% from 1993 onwards, and the ICORs shown in Annex A have been high and are projected at about 9 until 1993 with no projections provided afterwards, but can be surmised to remain roughly at the same high level. High ICORs for Egypt reflect many factors including overpriced investments, idle and unrepaired capital, inefficiency of use, bottlenecks, lack of imported inputs, relatively high infrastructural investments, and expenditure on oil and gas exploration. (See para. 8 which draws attention to the profusion of "suboptimal investments" which cannot produce efficiently.) The ICORs would be higher still if the depletion of petroleum were reflected in the reckoning of GDP.

- Can a special effort be made to get some production out of the existing suboptimal investments?

- In view of the fact that reducing capital formation may provide resources to facilitate structural adjustment, what are the possibilities of effecting such a reduction? Reduction apart, should not the composition of investment be changed away from infrastructure towards projects that can more readily enhance growth and quickly yield foreign exchange? And has enough effort been made to rationalize investment, identifying bottlenecks, particularly in industry? Should not Bank-supported investments show the way?

✓ Composition of Investment

Social Impact

7. In the two decades of the fifties and sixties Egypt was transformed into a centrally planned economy. A vast redistribution of income and wealth took place side by side with the rise of the army officer class. Since the economic liberalization drive that began in the mid-seventies, the distribution of wealth and income has certainly worsened and the public sector's grip on the economy, though loosened, is still tight. The improved incentives associated with the new inequalities have not been reflected in improved productivity owing largely to regulations and distorted policies. It is difficult to assess in terms of categories of income recipients, the impact of increased work opportunities that opened up in the petroleum economies, inflation, controlled prices and incomes, and the rise in contacts with the outside world. Much redundant labor exists in the public sector, but the pay is generally pitiful and the productivity tends to match the pay. Reforms introducing international prices without wage adjustment would cause large scale suffering to add to the suffering of the lower and fixedly paid members of society who have already experienced lower living standards. The government is thus reluctant to introduce radical changes which need time to devise and perfect and cannot be implemented in a hurry. In this context the CSP considers targetting the existing subsidies while attempting to reduce them, and setting up an "Emergency Social Fund" which, inter alia, would promote socially-oriented projects.

- The Region might wish to elaborate on the Social Fund concept; what is the size of the Fund and likely sources of finance?

✓ Social Fund

o As it would need time to develop instruments to reduce some of the side-effects of adjustment, can such measures be regarded as effective?

Economic and Sector Work

8. Because of the difficulty and scope of the Egyptian economic problem and the long reform agenda for reform, the ESW proposed is on the high side. Measured in staff weeks it is 176 in FY90; 219 in FY91 and 185 in FY92, about half of which is in economic work, and the other half covering various sector reviews and reports. The total seems commensurate with the need, and Egypt's share of this work appears reasonable compared with other countries. The sectoral work appears to be well targetted and does serve the dialogue, and guide the analysis and lending operations. The economic work program has in the past been dominated by a CEM, initiated in FY88, absorbing a total of 192 staffweeks (of which 13 in FY90), but has not been issued. The Region is seeking authorization for the ESW proposed, with emphasis on informal sector reports rather than finished products.

yes

o The Committee may wish to discuss the level and composition of ESW in light of the prevailing uncertainties.

The Lending Program

9. The proposed lending operations are set out usefully in Annex C with three levels of lending indicated, consistent with the low, base and high cases elaborated in the CSP, and the program is laid out for a five-year period.

~~[illegible] sharing~~ Cost sharing & Maintain [illegible] Subsidies until report comes

50-60%

o Notwithstanding the argument in para. 75 against the Bank's involvement in population, the Committee may wish to question the absence of a population project, and also the low case coverage of infrastructure operations.

o If the high case materializes, should not a financial sector loan be attempted, in which case the ESW for the sector be advanced?

Operations Committee

Messrs. Qureshi, Husain, Jaycox, Karaosmanoglu, Lari, Rajagopalan/ Fischer, Shihata, Kashiwaya, Wood, Vergin.

cc: Messrs. Lee, COD; Shakow, SPR; Holsen, CEC; Rao, FRS; Bock, CFS; Burmester/Thahane, SECGE; Goldberg, LEGOP; Gustafson, CEM; Ms. Okonjo-Iweala, OPNSV; El Serafy, EAS; Thalwitz, PPRSV; Parmar, IFC-CIO; Linn, IEC; Kavalsky, FRM; Pfeffermann, IFC-CEI; Liebenthal, SPRPA; Kilby, FRS; Robless, OPNSV; Ms. Haug, EXC; Khanna, EXC; Aguirre-Sacasa, EXT; Challa, PBDFR; Stoutjesdijk, EM3DR; El Maaroufi, EMNVP; Voyadzis, EM3CO.

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 23, 1989

P. 28 -

TO: Operations Committee

P 29. Risk

FROM: Vinod ~~Dubey~~ Vdubey, Director, EAS

EXTENSION: 78051

SUBJECT: MADAGASCAR - Country Strategy Paper; Operations Committee Meeting; Agenda

P 26

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1. The Operations Committee will meet on ~~Friday, October 27, 1989, at 11:00 a. m. in Room E1243~~ Wed. Nov. 1 4:00 pm to consider the Madagascar Country Strategy Paper. Please note that we have advanced the meeting to take into account the travel schedules of principals in connection with the visit of the President to Madagascar. The following represents a proposed agenda.

Background and Macro-economic Adjustment

2. Madagascar is one of the poorest countries in the world with a per capita GNP of about US $200. With a population of 11.6 million growing at 3% per year, it is endowed with diverse natural resources and a favorable climate. Agriculture is the main source of output, contributing 42%. However, agricultural and resource potentials remain to be more fully tapped.

3. After a prolonged period of economic decline due to unsuitable economic policies dominated by controls and large public sector involvement, the Government undertook an adjustment process beginning in 1982. The momentum of these reforms took a sharp turn after 1986, under the leadership of a long ruling Government which decided to change the policy course. The adjustment process involved economic liberalization towards more market-based policies and has been accompanied by some amount of political liberalization.

Committment to Reform and Its Sustainability

4. The Committee may want to ask the Region to comment on the committment of the Government to the reform process and its sustainability. In particular, the Region may want to address the following issues (related to paras. i (in conclusion) and 93 to 94):

- The potentials for political and economic unrest due to ethnic and regional tensions.

- The possible fallout from income distribution issues, i.e., the concentration of gains from the economic

liberalization and some peculiar economic policies still in effect (e.g., Procoops issue).

The Adjustment Program in Madagascar

5. The Region states that the main challenge for Madagascar is to complete the policy framework and the incentive system to lay the foundations for growth in the next decade. This requires stimulation of the private sector as the main source of growth coupled with Government policies in the social sector and investment in infrastructure.

6. The Committee may want to ask the Region to elaborate on the present adjustment process, especially the depth of reforms in trade, financial sector, tax, investment, public management including public enterprises, and labor market and foreign exchange rate policy. In particular, the Region may want to discuss the following:

- Why is the supply response inadequate or slow in spite of the reforms; are there missing elements in the reform process? Supply response

- What are the priorities for further reforms and how are these related to the sources of growth of the economy?

Projections and Base Case Scenario Page 17

7. The base case scenario (paras. 54 to 58) assumes a target rate of GDP growth of 4.5% for 1989-93, a continuation of the pace of economic reforms, and basically the same external economic climate. This scenario, however, is based on a higher performance of government revenues than perhaps warranted (about 22% of GDP, i.e., somewhat higher than the historical performance during the early 1980s, which was around 17% of GDP) and increased investment. The financing gap implied by this scenario requires a continuation of a high level of external financing, including a high level of local cost support for the Government programs. The program implies a further buildup of external debt, although the country is being considered a candidate for some level of market-based debt reduction.

Present 3.4 bill will go up to 4.8
Debt Service 50%.

Commercial or official debt?

8. The CSP uses two cases of downside scenarios (paras. 64 to 65), the first being related to a reduced public investment spending due to domestic factors and the second due to external factors, specifically poorer export receipts.

9. The Committee may want to ask the Region to elucidate on the realism of the assumptions of the base case scenario.

Bank Strategy and Assistance

10. The Bank has been the major source of finance for Madagascar since their independence. In recent years, Bank lending to Madagascar

had an increasing component of adjustment lending; about 50% of total loans had gone to adjustment lending since 1986. The Region proposes a lending program for 1990-94 amounting to US $561 million, of which 32.6% would make up adjustment lending (Annex D).

The Committee may want to ask the Region to:

- Explain why this proportion between adjustment lending and project lending is being chosen. Is there a case for a larger component of investment lending?

- Link the assistance strategy to the scenario regarding economic and reform performance. Since the lending program is tied only to the base case scenario (which, incidentally, is a high case scenario), what would happen to the lending program if worse situations arose. In short, what is the core program and what conditions would cause the assistance program to go to the core program?

- Discuss the burden sharing implications of the Bank program with the international aid community; to what extent is the Bank taking too large a share in the assistance effort?

- Comment on the feasibility of the debt reduction to relieve the heavy debt burden for Madagascar and the role of IDA in the process.

Economic and Sector Work and the Reform Process

11. The Committee may want to ask the Region to discuss how the economic and sector work planned relate to the reform and adjustment process.

12. In view of the market-based reforms directed towards private sector incentives, the Committee may want to ask the Region to elaborate on the sector work designed to improve private sector response.

13. The Committee may further ask the Region to elaborate on the efforts designed to meet social concerns that relate to the economic adjustment efforts.

cc: Messrs./Mmes Qureshi, Shihata, Fischer, Wood, Kashiwaya, Jaycox, Karaosmanoglu, Thalwitz, Husain, Vergin, Isenman, Lee, Shakow, Holsen, Voltaire, Goldberg, Bock, Rao, Burmester/Thahane, Gorjestani, Okonjo-Iweala, Schiavo-Campo

cc: Messrs./Mmes Hopper, Pfeffermann, Linn, Parmar, Steer, Liebenthal,
Kavalsky, Aguirre-Sacasa, Haug, Khanna, Robless/
Lawrence, Agarwala

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THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 25, 1989

TO: Operations Committee

FROM: Vinod Dubey, Director, EAS

EXTENSION: 78051

SUBJECT: MADAGASCAR - Country Strategy Paper;
Operations Committee Meeting;
Notice

An agenda for the Madagascar Country Strategy paper was circulated on October 23, 1989. There has been a change in day and time and the Operations Committee meeting has been rescheduled to take place on **Wednesday, November 1, 1989, at 4:00 p. m. in Room E1243**.

cc: Messrs./Mmes Qureshi, Shihata, Fischer, Wood, Kashiwaya, Jaycox, Karaosmanoglu, Thalwitz, Husain, Vergin, Isenman, Lee, Shakow, Holsen, Voltaire, Goldberg, Bock, Rao, Burmester/Thahane, Gorjestani, Okonjo-Iweala, Benbrahim

For Information Only

cc: Messrs./Mmes Hopper, Pfeffermann, Linn, Parmar, Steer, Liebenthal, Kavalsky, Aguirre-Sacasa, Haug, Khanna, Robless/ Lawrence, Agarwala

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GSicat/sb

November 1, 1989

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The World Bank
OPERATIONS COMMITTEE

Confidential

Minutes of Operations Committee to Consider
Lesotho Highland Water Project

Held on November 1, 1989 in Conference Room E-1243

A. Present

Messrs. M.A. Qureshi (Chairman)
A. Karaosmanoglu (ASIVP)
K. Kashiwaya (CFSVP)
S. S. Husain (LACVP)
V. Rajagopalan (PREVP)
D.C. Rao (FRSDR)
S. Sandstrom (AF6)
I. Shihata (LEGVP)
W. Thalwitz (EMNVP)
T. Thahane (SECGE)
H. Vergin (OPNSV)

Messrs. J. Besant-Jones (IENED)
P. Dufour (FRM)
M. Fardi (SPR)
R. Grawe (AF6)
R. Harris (COD)
D. Lee (COD)
R. McPheeters (FRS)
C. Morse (CON)
P. Rashid (COD)
J. Renkewitz (AFT)
A. Rigo (LEG)
I. Sam (AF6)
A. G. Zeijlon (AF6)
Mmes. E. Adu (LEG)
C. Cook (AFT)
Okonjo-Iweala (OPNSV)

B. Issues

1. The meeting was called to discuss the Lesotho Highland Water Project (LHWP). The discussion followed the main issues raised in COD's agenda of November 1, 1989. It focussed on, (a) project risks, (b) trust account arrangements, (c) nature of costs to be financed by the Bank, (d) environment protection measures, (e) riparian rights, (f) economic justification of the hydropower component, and (g) practicality and timing of conditionality.

C. The Discussion

2. The Region introduced the project by noting that LHWP was a large and complex scheme to be constructed over a 30 year period in 4 phases. It comprised the water and hydropower components. Lesotho would export water to the Republic of South Africa (RSA) for which the latter would pay all costs and a royalty. Water royalties and increased customs revenues from project-induced imports would provide a large inflow of foreign exchange and public revenues as well as provide business and employment opportunities to about 5,500 people. Lesotho would pay all costs of the hydropower component.

3. The water transfer component would be financed by debt raised by the Lesotho Highland Development Authority (LHDA). It had appointed a financial advisor (Standard Chartered Merchant Bank of London) to assist in developing a financing strategy, under which major contracts would be awarded to contractors who are able to raise financing from export credit agencies and commercial loans. A trust account would be set up, into which RSA would make payments for debt service. Bank financing was being provided for the water component only. The financing of the hydropower component would be from grant and concessionary funds.

4. The Bank had been involved with the project over a considerable period of time and had supported Lesotho through an earlier IDA credit (SDR 8 million) for design and engineering. Further, its participation would facilitate the raising of cofinancing from other sources. Processing of the project was linked to satisfactory progress on key macroeconomic conditions in the areas of budgetary management and economic planning, civil service improvements, public sector enterprises, industry and agriculture.

5. A wide ranging discussion of the project followed. The Chairman identified the main issue as minimizing project risks by timing the Bank's commitment when future uncertainties, such as financing and procurement, could be known and taken into account in project processing. Other Committee members noted the risks of construction delays, cost overruns and their impact on the project's economic rate of return and future viability, creditworthiness of RSA, and the image problem arising from the Bank financing being perceived as a disguised loan to RSA.

6. The Region explained that actions on project implementation and conditionality had been discussed and agreed with the Government of Lesotho. The processing timetable took into account future uncertainties with a view to minimizing risks to the Bank. Tendering for the project had already started and bids would be received by appraisal. Bid evaluation and awards should be completed by the time of Board presentation. Thus the Bank would know whether the contractors had been successful in raising the needed financing, and the terms and conditions of major contracts, and could react to any major or unfavorable changes in the financial or technical aspects. Also actions under project conditions were linked to project processing stages i.e., preappraisal, appraisal, and Board presentation, to ensure that actions concerning proposed reforms were taken. The Chairman added that this was a good example of the type of project in which Bank can bring to bear its skills and expertise in legal, economic and financial areas. Lesotho was surrounded by RSA and the strategy should be to exploit the economic opportunities presented by the country's location. Water was Lesotho's main resource and its export would be of major benefit to the economy. The Bank needed to take calculated risks and get proper guarantees. RSA's creditworthiness and its role in the project were an intrinsic part of the project risks as was the world's view of the loan.

7. The Chairman then asked about the trust account arrangements and whether they afforded adequate security for debt service. Other committee members also raised concerns on these arrangements and risks.

The Legal Department explained that all lending would be to LHDA. Under the treaty entered into between Lesotho and RSA, the latter would be obligated to pay the debt service on the water transfer component. A trust would be established in the United Kingdom and a Trustee appointed to manage the account. A "Deed of Undertaking" would be entered into between the Trustee and RSA, and a 'Trust Deed' between LHDA and the lenders. These would be enforceable under English law. In the event of default by RSA, the amount in the trust would be shared pari passu between the Bank and other lenders. Further, under the provision of he draft Trust Deed, the Bank would be able to require the Trustee to take action against RSA in case of a default.

8. The Chairman asked about the project cost elements that the Bank would finance. The Region indicated that Bank financing would be limited to project elements that would afford the Bank the overview of the project, be otherwise difficult to finance, and which the Region considers are essential for project implementation. This would be consistent with its role as lender of last resort. The Bank would disburse against expenditures for construction supervision, design work, technical assistance to LHDA and environmental action plan and compensation.

9. The issues of the project's impact on environment and riparian rights were also discussed. The Region explained that the environmental concerns associated with the project had been the subject of intensive studies. LHDA had prepared a complete program with the Bank's involvement, covering environmental protection, resettlement, compensation to affected people, and rural development. The water for export originated in the Lesotho Highlands and fed into the Senqu river (called the Orange River in RSA). The Legal member explained that Lesotho had earlier approached the United Nations Governing Council for Namibia for agreement to the project, which had been obtained. This may need to be reconfirmed following elections in Namibia. Lesotho and RSA were the only other parties to the project.

10. The Chairman enquired about the low economic rate of return of the hydropower component and the rationale for its inclusion in the project. The Region explained that the rate of return was based on projected tariffs payable to RSA, which were low by international standards. Government of Lesotho had required its inclusion in the project with the aim of reducing its energy dependence on RSA from which it imports electricity. Several donor agencies and firms had indicated their interest in this component. The European Economic Community and African Development Bank were agreeable to financing it. The financing would be on concessionary terms. The Bank's loan would not be used for this purpose. A suggestion was made that the Region look into the rate of return for this component.

11. The Chairman and Committee members also asked whether the proposed macroeconomic and other conditions, some of which were project related and others were not, were appropriate for this project and whether these could be enforced, particularly following the start of construction. Certain members felt that non-project conditionality should not be included. The Region explained the nature of the

conditions and the timetable. Actions by the Government on conditions were to be initiated by appraisal or earlier and implemented before Board presentation. The Chairman felt that while it was not desirable in general to include non-project conditionality, in this instance the project would be of such major impact on the economy that it would have a bearing on all key macroeconomic indicators. Further, such actions by the Government before Board presentation could only improve the situation. The Bank in effect was doing institution building up front.

D. Conclusion

12. The Chairman summed up by stressing that this was an extremely important project which the Region should continue to pursue. The project raised difficult issues of financial, technical and political risks for the Bank. The loan amount of $110 million was needed to provide the basis for the operation and leverage for appropriate actions. However, the Region should work to minimize project risks and commitment should be timed to when project risks and uncertainties were known and could be reduced. The legal agreements should ensure proper guarantees and security of debt service. The riparian rights issues should be addressed and the agreement of concerned countries obtained. The policy conditionality should be appropriately timed and implementable. The project together with a short note should be sent to the President for consideration.

PC#5/Rashid/AC3
PRashid:gms

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION
OFFICE MEMORANDUM

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1.

DATE: November 1, 1989

TO: Operations Committee

FROM: Ducksoo Lee, Director, COD

EXTENSION: 73348

SUBJECT: LESOTHO: Highland Water Project (Construction Phase 1 A) (LHWP) Agenda

(1) Trust Arrangement with S Africa 1st Phase are out, Form Magesa.

(2) Number of donors who are not willing to lend if S Africa to service. Unfair

1. The Operations Committee will meet on November 3, 1989 at 4:30 p.m. to discuss the above project. The Executive Project Summary (EPS) and Project Brief have been distributed by the Region.

2. Lesotho Highland Water is a large and complex enclave scheme to be constructed in 4 phases over the period 1990-2020. It is of considerable significance for Lesotho's economy and was highlighted in the Country Strategy Paper discussed by the Operations Committee on October 18, 1989. The project (Phase 1 A) comprises a water transfer component ($1,608 million) and a hydropower component ($220 million). Lesotho would export water to the Republic of South Africa (RSA) for which RSA will meet all costs and pay a royalty. A treaty to proceed with the implementation of the project has been signed between the two countries. The hydropower component is intended to overcome Lesotho's energy dependence on imports from RSA, and Lesotho would be responsible for its financing.

(3) Power Components Hydro not viable ERR.

3. The project would have a significant impact on the water and power sectors and would substantially increase Government revenues. The Region may wish to elaborate on the impact of such a large project on Lesotho's economy, and how the country's administrative and institutional capability (public sector management is currently considered weak), would be geared to addressing project management and implementation issues meaningfully.

4. A proposed condition of the project is that project revenues would be kept separate from other public revenues and used for development oriented programs. The Region may wish to comment on this requirement to earmark project revenues, and whether it would lead to reduced Government flexibility in the management of its resources.

5. The water transfer component would be financed entirely by debt raised by Lesotho Highland Development Authority (LHDA) with debt service payments guaranteed by RSA. RSA would make payment into a trust account to be established in the United Kingdom to service the debt. A trust agreement for this purpose would be entered into between LHDA, lenders and the trustee, under which the lenders including the Bank, would rank pari passu in the case of a shortfall of funds. The Region may wish to: (a) explain the implications of the Bank being treated on a pari passu basis with other lenders in the repayment of the IBRD loan. As the Bank would also require a Government guarantee, could servicing the Bank loan put an undue burden on Lesotho in the event of defaults by RSA?
(b) discuss possible reluctance of other potential donors to provide

financing which will be serviced by RSA; and (c) explain the possible impact of IBRD not financing the project and whether RSA would feel committed to step in to make up the balance.

6. In view of the difficulty of raising large foreign exchange financing (about $520 million, excluding IBRD contribution, for the water transfer component) in a small country like Lesotho, major contract awards would be made to qualified contractors who are able to obtain the support of their export credit agencies and commercial banks. Financing terms as well as price would be taken into account in bid evaluation. The Region may wish to explain the risks of this approach in terms of insufficient contractor response or their inability to secure the necessary financing, and of higher bid prices.

7. Lesotho imports electricity from RSA at tariffs which are among the lowest in the world. To avoid energy dependence on RSA, a hydropower component, expected to be financed by concessionary credits and grants, is included, but will have an economic rate of return estimated at 7%. The Region may wish to elaborate on the need and economic justification for this component, including the relative costs of electricity for the consumer with and without the hydropower component, and the current performance of the state owned electricity distribution entity.

8. RSA will pay Lesotho royalties corresponding to 56% of the savings realized by not having to implement a more expensive water scheme within RSA. The net present value of the benefits from all phases discounted at 6% (agreed in the Treaty) are estimated to be $605 million and at 10% are estimated to be $285 million, in 1988 prices. The Region may wish to elaborate on the nature and its own evaluation of the savings and costs of the more expensive scheme.

9. The EPS indicates that actions are being taken on the environmental protection and formulating compensation policies to ensure that there is no deterioration in the living standards of the population affected by the project. The Region may wish to explain the plans for environmental protection, resettlement and compensation of persons affected.

10. The project will face the risks of unsettled political conditions in the region and unforeseen construction and financial difficulties may emerge. The Region may wish to elaborate on the political, technical and financial risks of the project. what will we lending

2 At what stage shall the Bank make the commitment?

Distribution:

(3) 1st 7 4 plan - Phase 1

Messrs. Qureshi (OPNSV); Husain (LACVP), Jaycox (AFRVP)
Karaosmanoglu (ASIVP), Thalwitz (EMNVP); Rajagopalan (PPRVP), Fischer (DECVP); Shihata (LEGVP), Wood (FPRVP), Dubey (EASDR), Vergin (OPNSV)

cc: Messrs. Hopper (PPRSV); Bock (DFS); Goldberg (LEGVP), Frank (CEP); Shakow, Liebenthal (SPR), Holsen (CEC), Rao (FRS) Burmester/Thahane (SEC) Robless (OPNSV); Parmar (CIOVP), Pfeffermann (CEI), Linn (IEC), Kavalsky (FRM), Tanaka (EXC), Sandstrom, Sam (AF6), Wyss (AFT), Denning (AFRVP), Harris, Srinivasan, Casley (COD)
Mmes. Haug (EXC), Okonjo-Iweala (OPNSV)

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